26087: Labor and Finance - Corporate Ownership

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Recap

Overview

Overview on M&As

- M&As are driven by both **financial and strategic** motivations, often in response to market, industry or internal firm changes. → ”re-optimizing of the boundaries of the firm”
- M&As often involve large **discrete** changes in a firms human capital
- M&A activity **varies considerably** over time and across industries. Has trended toward larger, cross-border deals, more often involving financial buyers

Human Capital Motivations for M&As

- Human capital is a **critical driver** in many M&As:
    1. Corporate Governance Through M&As
    2. Expanding Internal Labor Markets
    3. Acquiring Monopsony Power
    4. Acqui-hiring
- A key question in the research on M&As is where the sources of **takeover premia** in M&As come from. Is there evidence of **value capture** or **value creation**?
- M&As can involve **externalities**: privately optimal M&As may not be socially optimal → regulation comes into play

How do M&As Affect Human Capital?

- Re-optimization of the **boundaries of the firm**:
  - Cutting redundant labor (implicit contracts, overlapping roles)
  - Modernization and technological change
  - Flattening of the firm
- **Career impacts** vary:
  - Productivity gains may be **shared through higher wages/lower layoff risk**
  - Investments may have **positive spillovers** on careers (knowledge transfer)
  - **ILM career options** may open up (specially for startups)
  - Layoffs can lead to **unemployment/health problems** with substantial negative career externalities (though not always)
- M&As likely involves substantial positive or negative **career externalities** → policy interest and regulation

Objectives for Today

- **Overview of key corporate ownership form:**
  - Family firms, state-owned enterprises (SOEs), listed firms, and private equity buyouts
- **Labor implications of corporate ownership:**
  - Analyze how different ownership forms impact **job security, wages, task allocation and career progression**
- **Government policy:**
  - Learn how government policies, including **taxation, privatization, IPO rules, and corporate governance standards**, can shape corporate ownership decisions and labor outcomes

Outline

An Overview of Corporate Ownership

Overview

An Overview of Corporate Ownership

- **Corporate Ownership Forms and Labor:**
  - **Ownership matters** because it influences decision-making and strategy of the firm
  - Owners have the ultimate **residual control rights** over firms and they get to set the **objective function** of the firm
  - This includes how the **economic rents are shared** between different **stakeholders**
- **Key Themes:**
  - Corporate governance
  - Job security and wages
  - Career progression and job tasks/allocation

Overview of Corporate Ownership Forms

- **Ownership forms we will cover**:
  - Family Firms
  - State-Owned Enterprises
  - Listed Firms
  - Private Equity Buyouts
- **Why these forms?**
  - **Diverse Impacts:** Each ownership form has unique characteristics that affect management practices and labor outcomes
  - **Global Relevance:** These forms are prevalent across different countries and industries

Key Differences in Objective Function

- **Family Firms:** Often prioritize stability and long-term relationships with employees.
- **SOEs:** May balance commercial objectives with social and employment goals.
- **Listed Firms:** Tend to focus on short-term financial performance, influenced by shareholder pressure.
- **Private Equity:** Typically driven by efficiency and profitability, often leading to restructuring.

Bloom et al. 2015: Management Practices Across Owners

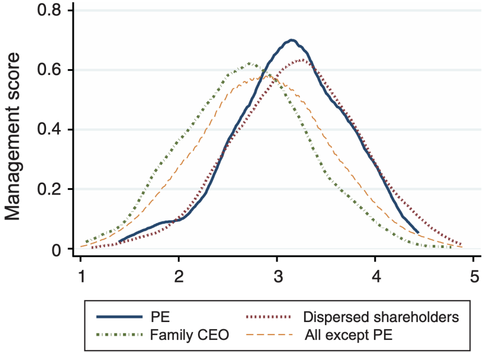

FIGURE 1. THE DISTRIBUTION OF MANAGEMENT SCORES ACROSS OWNERSHIP TYPES

Note: The kernel distribution of management practice scores for 15,038 firms, of which 465 are owned by PE, 4,076 by dispersed shareholders (publicly listed), and 2,539 by family and have a (second or greater) generation family CEO.

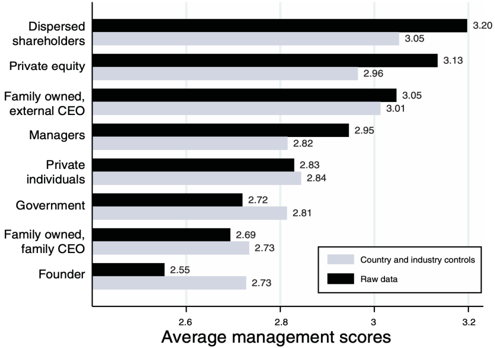

FIGURE 2. AVERAGE MANAGEMENT SCORES ACROSS OWNERSHIP TYPES

Notes: Management scores for 15,038 firms. Raw data and with country and three-digit SIC industry controls.

Trends Over Time and Across Countries

- **Family Firms:** Dominant in many emerging markets, but declining in influence in advanced economies
- **SOEs:** Common in strategic sectors, particularly in countries with strong government involvement in the economy
- **Listed Firms:** Increasingly prevalent in developed markets, driven by capital market growth
- **Private Equity:** Growing presence in a wide range of sectors, often in mature industries

Corporate Ownership and Human Capital

Overview

An Overview of Corporate Ownership

Corporate Ownership and Human Capital

- Family Firms
- State-Owned Enterprises
- Listed Firms
- Private Equity Buyouts

Government Policy

Takeaways

Corporate Ownership and Human Capital

Family Firms

Family Firms

- **Definition:** A family firm is a company where a family controls a significant share and is actively involved in management (CEO + shareholders + boardmembers)
- **Prevalence:** Common in both emerging and developed markets, especially in sectors like manufacturing, retail, and services
- **Key features:**
  - Long-term orientation
  - Close-knit management and ”glass ceilings”
  - Strong emphasis on legacy and continuity

What Makes Family Firms Special?

- **Stability and long-term focus:**
  - Family firms prioritize stability over short-term profits, focusing on long-term growth and sustainability
  - A desire to preserve **control of the firm** for future generations
    1. nonpecuniary benefits (firm bearing the family name)
    2. reputational benefits (product quality, political connections)
    3. preventing expropriation by non-family managers
- **Trust and loyalty:**
  - High levels of trust within the organization, often leading to strong loyalty from employees $\rightarrow$ firm specific investments
  - Relationships are typically closer and more personal, influencing both hiring and management practices

Family Firms and Labor

- **Wage comparisons:**
  - Family firms pay lower wages compared to non-family firms
  - Job security and non-monetary benefits (stability and support) partially offset this (but not always, see below)
- **Career growth and nepotism:**
  - Opportunities for advancement might be more limited
  - Leadership succession often based on trust and shared values (family continuity)
- **Impact on the workforce:**
  - **Employee morale:** Non-family employees may feel demotivated if they perceive limited opportunities for advancement
  - **Retention challenges:** Talented non-family employees might leave the company if they feel their career progression is blocked

Insuring Workers in Family Firms

- **Job Security:** Family firms may offer greater job security, particularly during economic downturns, as they prioritize maintaining employment for their workforce
- **Employee Welfare:** Investment in employee welfare can be higher, with benefits tailored to long-term employment
    - Examples include generous retirement plans, family-friendly policies, and support for employee development
- We will come back to **risk sharing within the firm** in Module 3 of the course

Sraer and Thesmar 2007: Performance and Behavior of Family Firms

- **Research question:**
  - Do family firms perform better than non-family firms, and how does family control affect firm performance?
- **Data and identification:**
  - French **publicly listed firms** from 1994 to 2000 + LEED survey
  - ROA/ROE, labor productivity, and wages
  - Comparison between family-controlled firms (founder-managed, heir-managed) and widely held firms
- **Findings:**
  - Family firms outperform widely held firms in terms of ROA/ROE, but pay lower wages
  - Family firms appears to smooth out how sales shocks transfer to workers over the business cycle

Porto et al 2024: Careers and Wages in Family Firms

- **Research question:**
  - How do wages and career trajectories differ between family and non-family firms?
- **Data and identification:**
  - Matched employer-employee data from Italian firms and workers
  - Wage decomposition, promotion, and firm data
- **Findings:**
  - Family firms pay **16% lower wages**; half the gap is due to worker characteristics
  - Family firms retain control, **limiting managerial opportunities for non-family members**
  - **Employment stability (and other amenities) is higher** in family firms, but this does not offset the wage gap

Key takeaways on family firms

- **Unique characteristics:** Family firms often provide a stable and loyal work environment, with a focus on long-term growth
- **Labor implications:** While wages may be lower, job security and non-monetary benefits can make family firms attractive employers
- **Challenges:** The potential for nepotism and limited career progression opportunities can pose challenges for non-family employees.

Corporate Ownership and Human Capital

State-Owned Enterprises

State-Owned Enterprises: Introduction

- **Definition:** State-Owned Enterprises (SOEs) are companies where the government owns a significant share or exercises substantial control
- **Prevalence:** Common in strategic sectors and natural monopolies like utilities, telecom, energy, transportation, and defense
- **Key Features:**
  - Dual objectives to balance **commercial success with social and policy goals**
  - Close government oversight and influence on decision-making
  - Often operate in sectors **critical to national interest or public welfare**
  - Managers face **soft budget constraints**

Soft Budget Constraints in SOEs

- **Definition:** Soft budget constraints refer to the tendency of SOEs to receive financial support from the government, reducing pressure to be financially self-sufficient.
- **Implications for Labor:**
  - **Job Security:** Employees in SOEs may enjoy greater job security due to government backing, even in financially difficult times
  - **Efficiency:** The lack of financial discipline can lead to inefficiencies, potentially impacting productivity and innovation
- **Examples:** SOEs in sectors like transportation or utilities often continue operations despite chronic losses, supported by government subsidies or bailouts

Employment Objectives in SOEs

- **Social and Political Mandates:**
  - Governments may use SOEs to achieve broader social goals, such as maintaining high employment levels or providing essential services at lower costs
  - Employment in SOEs can be seen as a tool for political stability, particularly in regions with high unemployment
- **Labor Practices:**
  - **Job Creation:** SOEs may be more willing to create jobs, even if not strictly necessary from a business perspective. They may also empire-build.
  - **Wage Policies:** Wages in SOEs might be influenced by social objectives rather than market conditions, sometimes leading to wage compression or above-market wages

How Do Privatizations Affect Workers?

- **Privatization:** ownership change from public to private hands
- **Labor market impacts:**
  - **Job Security:** Privatization often leads to restructuring, which can result in job losses, especially in redundant or non-essential areas
  - **Wage Adjustments:** Wages may be aligned more closely with market rates, which could mean reductions in sectors where SOE wages were above-market
- **Examples:**
  - **United Kingdom:** The privatization of British Telecom led to significant workforce reductions, but also increased efficiency and productivity
  - **Eastern Europe:** Widespread privatizations in the 1990s resulted in substantial layoffs but also opened opportunities for more dynamic job creation in emerging sectors

Olsson and Tåg 2024: Privatizations in Sweden

- **Research Question:**
    - How does privatization impact firms and career outcomes?
- **Data:**
    - Swedish firms undergoing privatization over a 20-year period
    - Detailed registry data on workers and firms
- **Findings:**
    - **Career impact:** Privatization leads to a **decrease in wages** and **increases in unemployment** partly offset by **government transfers**.
    - **Non-market outcomes**: no large effects on entrepreneurship, family, health, or household finance outcomes
    - **Firm impact:** Productivity improves, in particular when there is a **CEO change**
    - **Welfare gains:** Productivity gains 2-6 times higher than worker losses

Key Takeaways on SOEs

- **Dual Objectives:** SOEs often operate with both commercial and social goals, influencing their labor practices and overall efficiency
- **Labor Impacts:** Job security and employment levels in SOEs are often higher, but this can come at the cost of operational efficiency
- **Privatization Risks and Benefits:** Privatization can lead to job losses and wage adjustments, but also to improved firm efficiency

Corporate Ownership and Human Capital

Listed Firms

Listed Firms: Introduction

- **Definition:** Listed firms are companies whose shares are publicly traded on stock exchanges, making them accessible to a wide range of investors
- **Prevalence:** Common across most developed economies, particularly in sectors like technology, finance, and consumer goods
- **Key Features:**
  - Ownership is dispersed among many shareholders
  - Subject to stringent regulatory and disclosure requirements
  - Management is accountable to shareholders, often prioritizing shareholder value (”fiduciary duty”)
  - Regulations to prevent value extraction from minority shareholders

Dispersion of Ownership and Entrenchment

- **Ownership dispersion:**
  - Listed firms have a large number of shareholders, leading to dispersed ownership
  - This dispersion can dilute individual shareholder influence, placing more power in the hands of management
- **Agency costs due to dispersion can lead to entrenchment:**
  - **Definition:** Entrenchment occurs when managers gain disproportionate power, potentially making decisions that benefit themselves at the expense of other stakeholders (quiet life, empire-building...)
  - **Impact on Labor (-/+):**
    - prioritize short-term gains over long-term investments in human capital (-)
    - enrich workers at the expense of other stakeholder (+)

Cronqvist et al. 2009: Do Entrenched Managers Pay Their Workers More?

- **Research Question**
  - How does managerial entrenchment affect workers' pay?
- **Data and Identification**
  - Data from public firms in Sweden matched with worker-level data (1995–2002)
  - Use of CEO voting and cash flow rights to measure entrenchment
  - Analysis based various FE regressions
- **Key Findings**
  - CEOs with more control tend to pay higher wages
  - Financial incentives through cash flow rights reduce this effect
  - Higher wages are more pronounced for employees **closer to the CEO in the hierarchy** and for those **geographically closer to headquarters**

Short-Termism in Listed Firms

- **Definition:** Short-termism refers to the focus on achieving **short-term financial results** at the expense of **long-term strategic goals and performance**.
- **Drivers of Short-Termism:**
  - Pressure from shareholders for immediate returns
  - Quarterly earnings reporting cycles
  - Incentive structures that reward short-term performance
- **Impact on labor:**
  - **Job cuts:** Boosting short-term profits at the expense of long run capabilities
  - **Underinvestment in human capital:** Reduction in employee training and development

IPOs and Worker Careers

- **Initial Public Offering (IPO):**
  - An IPO is when a private company offers shares to the public for the first time, transitioning into a listed firm

- **Impact on employees:**
  - **Equity participation:** Employees might receive (or have) stock options/shares
  - **Organisational/cultural shift:** Change in how the firm is organized and run (professionalization, cultural shifts, changes in management ect.)
  - **Job security:** Increased scrutiny from shareholders can lead to layoff OR capital injection may lead to expansion and increased job security
  - **Career progression:** Opportunities may increase as the company grows due to additional financial resources, but the focus on performance might also introduce a more competitive environment

Bias et al. 2023: Going Public and the Internal Organization of the Firm

- **Research question**
  - How does going public through an IPO affect the internal organization of firms?
  - Specifically, what changes occur in hierarchies, management, and human capital?
- **Data and identification**
  - Data from 327 German IPOs and matched private firms (1984–2015)
  - DiD approach to compare IPO firms with private firms before and after IPO
- **Key findings**
  - More hierarchical, adding layers of management and increase in finance, accounting, and HR managers
  - Higher turnover, with more better-educated but less job-specific workers
  - Internal labor market becomes more active with higher promotion rates

Key Takeaways on Listed Firms

- **Ownership structure:**
  - Dispersed ownership of listed firms can create **entrenchment**, **short-termism**, and a greater focus on **shareholder wealth**
- **IPOs:**
  - Often leads to **professionalization** and improves the **financing capabilities** of the firm
- **Labor Implications:**
  - Being listed or listing can **benefit** or **harm** workers
  - **Short term**: higher/lower pay and more/fewer layoffs
  - **Long term**: less training, less career development, fewer internal opportunities

Corporate Ownership and Human Capital

Private Equity Buyouts

Private Equity Buyouts: Introduction

- **Definition:** A PE buyout occurs when a private equity firm acquires a company, often taking it private and restructuring it to improve profitability
- **Prevalence:** Common in mature industries such as manufacturing, retail, and healthcare. But really everywhere where there are assets that can be leveraged nowadays...
- **Key features:**
  - Focus on short- to medium-term profit maximization.
  - Significant restructuring, often involving changes in management and operations.
  - Use of leverage (debt) to finance the acquisition.

The Private Equity Business Model

- **Partnership:** General Partners and Limited Partners
- **Management company:** Controlled by the general partners and takes a 20% carry over a hurdle rate of 8%, also takes a management fee of 2%.
- **Fund:** Limited time span of around 10 years, takes in **commitments**, invests in 5-10 companies, and pays out **disbursements**
- **Portfolio company:** Acquired by the fund, restructured, and resold before the fund closes

The Private Equity Business Model

- **Financial engineering:**
  - PE firms typically use high levels of debt to finance acquisitions, aiming to enhance returns through financial leverage.
  - The acquired company's assets and cash flows are often used to secure and repay this debt.
- **Value creation strategies:**
  - **Governance Engineering:** Management teams (CEO and board) are given equity stakes to align their interests with the PE firm
  - **Operational Engineering:** Streamlining operations, reducing costs, and improving efficiency, divesting non-core assets, focusing on high-margin products or services.
- **Exit Strategy:** Selling the company at a higher valuation through an IPO, secondary buyout, or strategic sale.

The Impact of PE Buyouts on Workers

- **Job Security:**
  - PE buyouts often lead to restructuring and layoffs and increases bankruptcy risk
  - Focus on cost-cutting and unemployment can increase uncertainty and stress among employees
- **Wages and Benefits:**
  - **Short-Term Pressure:** There may be downward pressure on wages and benefits as PE firms seek to reduce costs
  - **Long-Term Potential:** Successful **turnarounds** and **growth LBOs** can lead to better pay and career prospects

Olsson and Tåg 2017: Private Equity, Layoffs, and Job Polarization

- **Research Question**
  - How do private equity buyouts affect layoffs and job and wage polarization?
- **Data and Identification**
  - Data from employer-employee matched dataset in Sweden (2002–2008)
  - DiD analysis comparing firms pre- and post-buyout with controls
- **Key Findings**
  - No overall increase in unemployment, but doubling of layoffs for routine and offshorable jobs
  - Layoffs concentrated in firms with lower ex-ante productivity. Evidence for modernization.
  - Job polarization more pronounced in buyout-affected firms than in the broader economy.

Key Takeaways on Private Equity Buyouts

- **PE Business Model:** Build on **incentive alignment** and **leverage** to drive change in portfolio companies in the medium run (5-10 years)
- **Job Security:**
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Government Policy

Overview

Policy

- **Purpose:** Government policies play a crucial role in shaping corporate ownership structures and their impact on labor markets.
- **Some key policy dimensions:**
  - Taxation
  - Privatization Policy
  - Securities and Corporate Governance Regulations

Taxation and Ownership

- **Corporate Taxation:**
  - Different **tax rates and deductions** can influence whether firms choose to remain private, go public, or change ownership structures
  - For instance, the tax shield of debt generates an incentive to take on heavy leverage
- **Capital Gains Tax:**
  - Policies around capital gains taxation impact the attractiveness of selling or restructuring ownership stakes and the means of payment
  - Higher capital gains taxes may discourage private equity exits or incentivize longer holding periods
- **Inheritance Tax:**
  - Finland, for instance, imposes progressive inheritance taxes on the transfer of wealth
  - Heirs may face liquidity constraints due to high tax burdens, which limits family successions

Privatization Policy

- **Definition of Privatization**:
  - Transfer of ownership and management of state-owned enterprises (SOEs) to the private sector.
- **Objectives**:
  - Increase efficiency and competitiveness of formerly state-owned entities.
  - Reduce the fiscal burden on the government.
  - Encourage private sector investment and innovation.
- **Methods of Privatization**:
  - Public share offerings (e.g., IPOs).
  - Direct sale to private investors.
  - Management and employee buyouts.

Securities and Corporate Governance Regulations

- **Securities Regulation:**
  - Strict regulatory frameworks govern the process of taking a company public, ensuring transparency, investor protection, and market integrity
  - Regulations include disclosure requirements, reporting standards, and compliance with governance norms (often to protect minority shareholders)
- **Board Composition Rules:**
  - Regulations may require a certain number of independent directors, gender diversity, or worker representation on corporate boards
  - Aims to improve transparency, accountability, and decision-making within firms
  - Good governance practices can lead to more stable and equitable labor relations, reducing the risk of conflicts and ensuring fair treatment of workers
  - Example: Co-determination laws in Germany require worker representation on the boards of large companies, influencing decisions that affect the workforce

Takeaways

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