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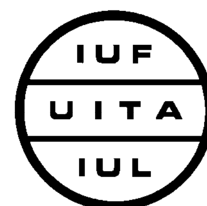

International Union of Food, Agricultural, Hotel, Restaurant, Catering, Tobacco and Allied Workers' Associations

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London, February 27, 2007

PRESENTATION TO TRADE UNION SPONSORED LABOUR MPS ON PRIVATE EQUITY AND LEVERAGED BUYOUTS

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To understand private equity, where it comes from, how it works, and what is its impact, I believe we have to take a look at the broader environment in which it functions. That means understanding the larger changes in recent decades to the way companies finance and run their operations and what it means for workers and the economy generally.

The main factor driving developments here is the transformation of share ownership and increased corporate reliance on "institutional investors". These are the investment banks, insurance companies, and public and private pension funds who have provided the capital for the mergers and acquisitions of the past 15-20 years. In North America, for example, institutional investors account for 75% of all stock trades. Thirty-five percent of global investment is financed by pension funds. This new form of investment capital is volatile, highly mobile, and linked to a variety of new financial instruments based on debt. This is what we mean when we talk about *financialization* of the economy. Financialized capital is not only highly **concentrated,** it is extremely **impatient**, demanding short- term rates of return on the order of 15-20%, and rising. In the hotel sector, for example, the international hotel chains are under pressure to match financial market leaders like InterContinental Hotels Group (IHG), which returns 16% to shareholders every year.

The same pressure for high rates of return is driving restructuring and closures in the food and beverage sector. In February last year, for example, Nestlé - the world's largest food company - announced a 21% increase in net profits and a 12.5% dividend. They also announced they would allocate 1 billion Swiss francs for a new round of share buy-backs in addition to the 3 billion franc share buy-back implemented only three months earlier. The same dynamic is driving restructuring, closures and sell-offs in Unilever. Investors have been promised that the elimination of 20,000 jobs will "release" 30 billion US$ to fund dividend payouts and more share buybacks. When the company sold its frozen foods division last year to Permira for €1.7 billion, every cent of the after tax profit on the deal was returned to shareholders. When you read that a company is divesting itself of this or that division to concentrate on its core business, take a closer look at where the money from the sale goes - it's not going into investment, its going back to financial investors, in many cases 100% of it.

What this means in practice is that the real economy of goods and services has been subordinated to the competitive logic of global financial markets. Food companies, for example, are no longer simply competing in yogurt, or carbonated drinks, or processed meats. They are competing on global financial markets to deliver the fastest and biggest possible rates of return to these new, impatient, financial investors.

One important consequence of this is the **declining rate of real investment** as a percentage of company cash flow. (The other side of this relative decline in real investment is the steady inflation of bonuses, executive salaries, stock options, dividends etc.). Less and less income is retained internally as investors grab more. This means that in many leading companies even R&D has stagnated or declined relative to cash flow. Productivity is boosted in the short-term though reducing payroll, increased reliance on outsourcing and casualization, and simply extracting more with less by inducing *competition between individual units within the firm* on the basis of the existing plant and equipment. All of this results in a general degradation of working conditions, and it is clearly not sustainable.

In effect, financial investors have imposed a levy on the real economy of goods and services. These are the kinds of pressures to reward short-term financial investors which drive Unilever to sell a division containing some of the most productive facilities in the UK and Europe. This is why Nestlé has no money to invest significantly in its Rowntree facilities in York, where it announced over 600 redundancies last year, at the same time as it spent 4 billion Swiss francs on buying back its own shares. Confirmation of this analysis comes from no less a source than Nestlé's CFO, who late last year admitted that Nestlé's capital stock was "dangerously" weak.

So the corporate environment in general is dominated by short-term investment strategies geared to maximizing financial rewards. Companies which favor long-term, strategic investment and fail to drastically reduce their payroll are severely punished by the markets. This is the dynamic behind what the French call "stock market layoffs." If investors are squeezing their portfolios to generate bigger and bigger returns, where is all this money going? One destination is increasingly private equity buyout funds - enormous pools of money provided largely by institutional investors and managed by the fund for the purpose of acquiring other companies in whole or in part, delisting them from stock exchanges if they are publicly listed, restructuring them and then selling them to other investors, either through public stock offerings or to another buyout fund. While private equity firms have traditionally set targeted rates of return of 20 to 25% annually, the largest funds have generated returns of 40% a year over the past 10 years.

The general tendency for investors to squeeze company cash flow and sell off physical assets in pursuit of short-term profits is accelerated and compressed in the private equity buyout process. When we talk about private equity, we're really talking about leveraged buyouts. Leverage is just another word for debt, and there's nothing new about leveraged buyouts. They were big in the US in the 1980's, culminating in the famous 38 billion-dollar buyout of RJR Nabisco that produced a book, a movie, and a wave of junk bonds that eventually landed some traders in prison. They also destroyed a number of companies, including Nabisco, and a lot of workers' lives.

The private equity industry deliberately cultivates confusion about their operations by organizing into so-called Venture Capital Associations. But venture capital - startup money for new firms - is only a very small part of what they do. In fact generally less than 10% of private equity investments go for startups, and in the UK it's on the order of 6-7%.

European private equity deals hit €178 billion last year, a 40% per cent increase over 2005. Eighty percent of this went to buyouts. In the last quarter of 2006, two-thirds of the buyouts were deals for over €1 billion. The big deals in the UK last year were Bird's Eye and the €2.3 billion takeover of United Biscuits. Number three in the UK was restaurant owner Gondola Holdings (Pizza Express) for more than 1.3 billion. So we're talking about big companies, with significant assets and large payrolls. But it's above all the cash flow that attracts leveraged buyouts, which are designed to deliver quick, big returns. Here's how it's done.

Company purchases are financed through heavily "leveraged" deals in which the private equity fund provides some 20% of the cash and the rest is borrowed. In the UK, this typically takes the form of a limited partnership, with the fund manager as a General Partner. The fund managers get an annual management fee, plus additional fees for each financial service (usually new loans) all of which can total up to as much of 5%. Imagine the sums involved when you're dealing in billion dollar investments. Also keep in mind that there is no VAT on these fees. When the acquired company is sold, the funds get a percentage of the profit - normally 20% - which is called "carried interest".

In theory these generous rewards are compensation for the risk taken by the private equity fund, but that's not what really happens. Once a company is bought, the new owners take on additional debt to finance large dividends through a mechanism known as "dividend recapitalization" ("recaps"). With dividend recaps a significant part of the initial investment is quickly recouped. For example KKR, Carlyle and Providence paid themselves a USD 250 million dividend in October 2004, *only a month* after putting 550 million into a USD 4.1 billion deal for satellite operator PanAmSat Corp. As one private equity executive remarked at the time, "If you can return capital early to limited partners, it's a no-brainer". The workers are left to shoulder the risks and the cost.

Permira bought the German chemical company Cognis in 2001 for €2.5 billion, using only 450 million of their own money. In 2000, the company had an after-tax profit of €109 million. Staggering under accumulated interest payments, despite rising sales it last year *lost* 136 million, and has begun laying off workers as it heads for possible bankruptcy. Yet Permira and Goldman Sachs have already taken out €850 million.

According to Standard and Poors, global recapitalization in private equity increased tenfold from 2002 to 2005. Recaps now account for close to a third of all income flows back to the new owners in the global private equity sector. The target company, stuck with the burden of repaying the loans and the various financial fees which accrue to the buyout fund, pays for its own takeover as equity is transformed into debt. The consequences of these financial mechanisms for management strategy

can only be asset stripping as cash flow and financial reserves are plundered, investment reduced and payrolls slashed.

As the deals get bigger, the debt increases not only in absolute terms, but also as a percentage of the operation. Buyouts used to be based on a calculation that profits could be made if the purchase price were a multiple of up to six times the target company's free cash flow. This is called the debt multiple. Debt multiples have almost doubled in the last three years, hitting an average 10.2 times free cash flow for deals over GBP 100 million.

The debt is financed in two ways, either directly by the banks in the form of high-risk bonds, or indirectly in the form of securitized debt, in which case a portion of the risk is offloaded on to other financial agencies. Increasingly we're seeing hedge funds investing more and more in these instruments and in private equity generally. All of this adds up to a debt mountain which is extremely insecure and threatens the health of the UK and global financial systems. A rise in interest rates, the collapse of a major hedge fund (and we've already seen two big ones fail in recent years), a drop in the stock market or the failure of one or more of the big buyout funds could shake the whole structure. This is what has prompted warnings from the UK Financial Services Authority.

An important development to note is the growing tendency for private equity investors to sell to other private equity funds instead of going public again. Some 40% or more of all private equity deals now go through secondary, tertiary buyouts or even more, as in the case of Little Chef. With each transaction of this sort, the debt increases exponentially, and the job cuts bite even deeper. According to the rating agency Fitch, the overall debt level of European companies owned by private equity is close to six times annual cash flow, and rising. Even when, against all odds, restructuring allows a company to grow, it is buried under a pile of debt which makes growth extremely insecure. So when we evaluate the claims made by the private equity lobby about revitalizing the companies they buy, creating new dynamic businesses etc., we have to take all this into account. The real indicators are not the sale value, but the long-term prospects for growth. We have to take a much longer perspective than the 3 to 5 years which the private equity industry calls "long term". Time constraints and the combined pressures of the debt and the investor appetites absolutely work against sustainable and innovative investment and development. There are simply no resources available. Assets have to be stripped.

Here are a couple of examples.

The Danish telecommunications operator TDC was taken over in 2005 by a group of five of the biggest private equity firms - Permira, Apax, Blackstone, KKR and Providence Equity for €12 billion, the record European deal at the time. Over 80% of the purchase price was debt financed. With the purchase the company's debt to asset ratio jumped from 18% to over 90%, at higher interest rates than what they'd previously been paying. The equivalent of over half the company's assets were then immediately distributed in shares to the new owners and top managers. The only reason we know this is that the private equity consortium didn't succeed in buying 100% of the shares: union pension funds managed to retain enough to keep it listed and guarantee minimum disclosure, although no one has been able to explain the

new owners' strategic plan. Reserves that the company had set aside for long-term development are now depleted, and the owners plan to sell the company within 5 years of its purchase. Some estimates reckon that the Danish government will have lost over €2 billion in tax revenue through this deal, which could easily wreck the company.

Unlike TDC, which had successfully restructured before the buyout, Eircom, Ireland's national telecom provider, was a company in need of long term strategic investment. The company was privatized by the government in 1998 and acquired by the private equity consortium Valentia in 2001. Eircom paid for the loans by issuing bonds which raised its debt from 25% to 70% of its assets. Eircom capital expenditures declined from €700 million in 2001 to 300 million in 2002 and 200 million in 2003 and 2004. *While cutting back radically on investment it paid a €400 million dividend to Valentia.*

These examples are typical. At a time when buyout funds are expanding into a whole range of public service activities including transport, telecommunications, health care and even education it is time to ask whether we want to turn over the provision of vital public services to this kind of predatory financing.

I would like to make three more points. First, the impact of private equity is not limited to the companies it acquires. The funds have gotten so big that virtually every publicly listed company is now a takeover target. 2007 is being talked about as the year of the 50 billion-dollar buyout deal. The response of listed companies fighting a takeover bid is invariably to slash costs and payrolls. You can see this clearly with the retailer Coles Myer in Australia, which tried to resist a buyout by slashing 2,500 jobs to show it was serious about "delivering value" to shareholders. Now that Texas Pacific Group has taken it over, more job cuts are expected. A pre-bid environment hangs over the economy as a whole, meaning short termism is institutionalized, bringing with it more job cuts and more attacks on wages and working conditions and more attacks on trade union rights.

Second, existing legislation at nearly every level fails to take account of the role of private equity as employers. We've all seen the figures on UK employment and private equity - companies owned by the funds employ up to one in 6 private sector workers. The funds actively intervene in management decisions, imposing layoffs and restructurings. They make decisions affecting the lives of millions of British workers, yet they call themselves an "asset class" rather than employers. Blackstone, the largest US private equity fund, owns companies employing 380,000 workers around the world, but claims to have only 500 employees. KKR, Blackstone and TPG own & control companies with USD130 billion in assets. They employ over 1.2 million workers around the world, including the UK. Each fund employs more overseas workers than any of the top ten TNCs in the world, including GE, which is generally rated number 1 in the TNC league. But the funds aren't recognized as employers by national governments or international agencies. Even in the European Union they operate in a parallel universe outside legislation establishing and enforcing employer responsibilities, like the Acquired Rights Directive. The funds are focused entirely on exiting the investment. From this point of view, employees are merely an expense, and we've seen the kinds of industrial relations practices this leads to. This situation clearly has to change.

Finally, I want to remind you, as Members of Parliament, that the explosive growth of the buyout funds in recent years is not a natural process arising from the normal workings of a market economy, but is in fact the result of pressure to change laws and regulations which spring from a well organized investor lobby. Leveraged buyouts can only grow and expand when very specific conditions are met concerning areas like capital gain tax, corporate legal structures, offshoring arrangements, pension fund investments and so on. It took only one change to the German federal tax code - the abolition of capital gains tax on the sale of businesses in 2003 - to pave the way for what many in Germany now call the locusts, which in a few years have bought up some of Germany's leading companies, in whole or in part. Locusts describes the way they eat up assets, but it's not helpful in understanding where they came from. They're not a biblical plague or a natural disaster, they arrived in the wake of a massive lobbying effort and very specific political interventions. Political intervention, through laws and regulations, has the power to block their expansion.

Markets, and financial markets in particular, have always required regulation, not least to keep them from self-destructing. We're being told that returning value to investors is in everyone's interest, because investors know best how to invest. This is false, because what is best for the individual investor is not necessarily best for the individual company, its workers, the wider community or the economy as a whole. Investors cannot be forced to invest, but regulation can choke off the more destructive destinations for investor capital and channel it back into useful activity which benefits society as a whole through contributing to sustainable long-term growth.

The UK private equity lobby is on the defensive, and to defend itself it is making a series of highly dubious claims concerning their contribution to the UK economy. None of these claims will stand up to serious scrutiny. I therefore think it's time to launch an open, transparent and thorough parliamentary investigation of the private equity industry in the UK as part of taking action to stop this threat to the UK economy and society. This should be linked to the growing debate on private equity currently taking place in European capitals and in the European Parliament.

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The International Union of Food, Agricultural, Hotel, Restaurant, Catering, Tobacco and Allied Workers' Associations (IUF) is an international trade union federation composed of 371 trade unions in 128 countries with an affiliated membership of over 2.8 million members. It is based in Geneva, Switzerland.