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Seminar on

Private Equity Funds

The harsh realities

Thursday 19 April 15:00 - 18:30

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Altiero Spinelli Building, room A3G-2
(Interpretation in French, German, English and Spanish)

Evidence from the International Union of Food, Agricultural, Hotel, Restaurant, Catering, Tobacco and International Union of Food workers (IUF)

Private equity seen from the angle of a sector seeing some of the most aggressive leveraged buy-outs

Programme

Speakers:

Peter Rossman, IUF Communications Director

Poul Nyrup Rasmussen, PES President

John Monks, ETUC General Secretary

Discussion, questions & answers:

Conclusions:

Ieke van den Burg, Socialist group ECON Coordinator

Moderator:
Stephen Hughes: EMPL Coordinator

The Impact of Leveraged Buyouts in the European Food Industry

The IUF is an international trade union federation in food, agriculture, hotels, restaurants, catering and tobacco. Our current membership is made up of 365 trade unions in 122 countries representing some 12 million workers.

The IUF has always viewed the production of food as a basic social service and not simply a business among others. The importance of food for life, for health, for the environment and for employment should be self-evident. What I would like to do here today is examine the situation of the European food industry in the light of long-term changes in financial markets and the impact of private equity within those changes. I then want to look at some of the key goals in the Lisbon program to assess whether current trends are consistent with these goals, and if not, what kinds of measures might be required to get us moving in a different direction.

Food processing in the EU is one of the key industrial sectors for a number of reasons:

- food is the largest employer in the manufacturing sector, ahead of automobiles and chemicals;

- it produces 10% of the manufacturing sector's contribution to GDP and the largest share of value added within that sector;

- it employs 3.9 million workers;

- and it is *destroying jobs* at a very fast rate. In the period 1999-2004, the overall decrease was from 4.4 to 3.9 million workers, representing a loss of 15.2% - behind agriculture but ahead of e.g. textiles, transport, telecommunications and other sectors *despite* rising turnover.

Of these job losses only 5% were due to "offshoring" production outside the borders of the EU. The vast majority were in fact due to closures, mergers and acquisitions rather than the introduction of new technology, which has not fundamentally evolved over the past decade or even more. Productivity increases over this period are largely attributable to job reductions and plant closings following on takeovers, outsourcing by biggest producers, and the growth of production by third party contractors.

If we look at the structure of the food manufacturing industry, we see that it is very highly skewed:

- 99% of companies are SMEs

- employing 61% of the workers and producing 49 % of turnover

- 51% of turnover is produced by 1% of the companies which are the transnationals of which

- the 10 largest TNCs have 12% of the turnover.

The food industry operates in relatively mature markets which have reached saturation. There is intense competition among medium-sized enterprises which are disappearing at an accelerating rate, and a large number of micro enterprises producing for niche or local markets.

A 2006 study by the European Foundation for the Improvement of Living and Working Conditions characterised the employment situation in these words:

"The implications for the food-sector labour market are likely to be more mass redundancies among blue-collar workers in medium sized production facilities in Northern and Western Europe."

To this I would add that job losses were even greater than predicted for 2006, and there were continued redundancies at the TNCs, not only at medium-sized production facilities.

The same study also notes that in the context of growing competition

"Developments in the food industry are creating a demand for employees with higher skills, both sector-specific and overall."

I would like to now highlight three issues arising from this brief overview in light of the Lisbon program's goal to make Europe "The most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth, more and better jobs and better social cohesion."

This programme was summed up by Poul Rasmussen in his presentation here a few weeks ago as the need for "Constant, high, long-term investments requiring a minimum 1 trillion euros" and the pursuit of a "smart green growth strategy".

The first point I would like to make is that the dramatic decline in food industry employment we've just seen is the consequence not only of the disappearance of medium sized companies supplying local and national markets, but of massive and continued closures following on mergers and acquisitions by the transnationals. As a result, there are fewer bakeries, breweries, meat packing plants and so on with far, far fewer people baking bread, brewing beer and processing meat, and those who do these jobs are increasingly doing them for the TNCs. The result is not only big job losses, and in most cases a loss of public revenue since comparable jobs are clearly not being created as fast as they disappear, but an enormous increase in the distances travelled by processed food products from farm to consumer, most of it travelling by road.

From an environmental point of view the trend is towards a steeply rising carbon emission content in the food we eat. Since the whole pattern of production and distribution depends on cheap energy it is clearly not sustainable. Much of the research being carried out by the food industry today is based on the assumption that food will continue to be transported over even longer distances and so is focused on enhancing shelf life. The process is highly destructive of both jobs and the environment and is clearly taking us away from the Lisbon goals.

The second issue is the need for investment in skills training and for research and development generally in the context of saturated markets and intensified competition. I'll return to this when we look later at what's happening with corporate financing.

The third point is the key role of the transnationals in setting tends and driving developments in the sector, and that's where I would like to turn now, because if you want to understand the sources and the dynamics of private equity you have to understand 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. This 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 food sector, expected rates of return to investors have more than doubled over the past 10-15 years, and it is this pressure for high rates of return which is driving restructuring and closures. In 2005, Nestlé - the world's largest food company - announced a 21% increase in net profits and a 12.5% dividend. They also spent a record 4 billion CHF on share buybacks. At the same time thousands of jobs have been eliminated, outsourced or casualised. If we look at breweries: in 2005 Heineken announced that second-half profits had increased 56 per cent over the previous year while announcing that 1,000 jobs would be cut in the next 12 months. InBev, the largest brewery TNC, announced a 15.3 per cent increase in earnings while simultaneously announcing substantial job cuts.

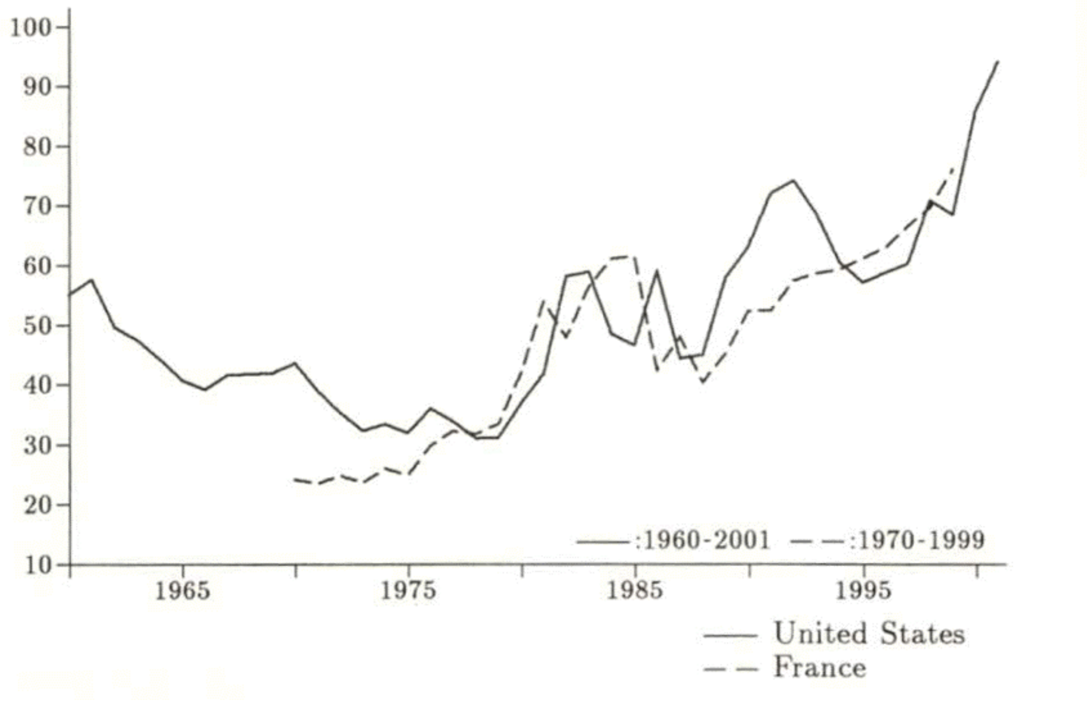
The same dynamic is driving restructuring, closures and sell-offs in Unilever, the second largest food company in Europe and number 3 globally. Investors have been promised that eliminating 20,000 jobs will free 30 billion US$ to fund dividend payouts and more share buybacks. When the company sold its frozen foods division last year to the private equity firm 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 yoghurt, or carbonated drinks, or processed meats. They are competing on financial markets to deliver the fastest and biggest possible rates of return to these new, impatient, financial investors. In 2005, Deutsche Bank chief Ackermann stated that investors should be aiming at a 20% rate of return. Last year, at the Deutsche Bank general board meeting, he gave the keynote address, and the theme was: 25% is not enough!

This is the meaning of what we call the financialised corporation. The new corporate financial logic has been described as being based on a view of the company as “a bundle of assets to be deployed or redeployed depending on the short-run rates of returns that can be earned.”

One important consequence of this change in management focus is that less and less income is retained internally as investors grab more, resulting in a **declining rate of real investment** as a percentage of company cash flow. 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 casualisation, 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.

One way to visualise this is by looking at dividends as a percentage of corporate profit.



This graph shows why Nestlé, for example has no money to invest in its Rowntree facilities in York, where it announced over 1,000 redundancies last year, at the same time as it spent 4 billion Swiss francs on buying back its own shares. Products formerly produced in York will now be imported from Germany. Here we see clearly how short term pressure for increasing returns means an investment strategy which delivers fewer jobs, more food kilometres and rising carbon emission content - all of which take us farther from the Lisbon goals.

Companies which favour long-term, strategic investment and fail to drastically reduce their payroll are severely punished by the markets. So if investors are squeezing their portfolios to generate bigger and bigger returns, where is all the money going? One destination is increasingly private equity buyout funds.

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 greatly accelerated and compressed in the private equity buyout process.

If the publicly listed company is simply "a bundle of assets" to deliver maximum "shareholder value", the role of private equity can be described as a further transformation in management strategies which the funds like to call "unlocking value". Unlocking value simply consists of **unbundling** corporate assets to squeeze cash flow even harder to return *more* money even faster by going private through a private equity buyout.

The classic example is the famous USD 31 billion buyout of RJR Nabisco by KKR in 1988, until recently the mother of all buyout deals. Many people know this through the book Barbarians at the Gate, or the movie, or they've heard about junk bond dealers going to prison. What they don't know, but our members lived through, is that the deal destroyed the company as an employer with productive assets and a workforce. Nabisco was reduced it to a legal fiction essentially consisting of a bundle of brands which made the investor rounds before winding up at Kraft, a company itself on the verge of implosion and a likely candidate for wholesale dismemberment by private equity. In the process, tens of thousands of unionised jobs were destroyed globally.

Looking again at the food processing industry, a typical example of what happens to a company when private equity drains the cash flow to service debt and achieve quick returns is the case of Findus, formerly the frozen foods division of Nestlé.

Findus was acquired by EQT, the Swedish private equity fund, in 2000 in a typical leveraged buyout. At the time of purchase the Findus Group was composed of 14 plants throughout Europe - including 2 in Sweden - with 3,400 employees. Today there are 6 plants - only one left in Sweden - with 2,900 workers. Research staff at the company's Swedish headquarters has been reduced from 200 to 40.

Since the market for frozen foods is in general diminishing as consumers shift to other convenience prepared foods, the Findus story is a prime example of what happens to a company in need of substantial investment in research and innovation, but due to the economics of the buyout business is compelled to redirect cash flow away from precisely those areas most needed to secure its future. Findus was so overwhelmed by interest payments that despite boosting its earnings to equity ratio through extensive closures and selloffs, it could not organise a public stock offering in 2003 and even failed to arrange a secondary buyout. According to union representatives on the board, it was struggling to pay its bills for most of the period.

Findus was acquired last year by another private equity firm, CapVest, in an operation which will undoubtedly pile on new debt.

I would urge you to look at this experience in light of the Lisbon goals - the need for sustained, long-term investment and the smart green growth strategy. Consider that private equity buyouts in the European food industry are on the rise, and ask yourselves whether we want, or we can afford, to replicate the Nabisco or Findus experience on a European-wide scale, because that is what is happening every day in the food companies which private equity has already acquired.

Private equity deals in the European food sector completed or pending in the first quarter of 2007 reached €12.8bn before the end of March. Total deals for the whole of 2006 were what seems now a mere €10.6bn. This is the threat hanging over food workers in the EU and globally, and the IUF believes that action is required to meet that threat.

You now have the study on private equity and hedge funds produced by the PSE in March. The report is excellent and there is no need repeat here what you can read there. What I want to do now is to draw your attention to, first:

The impact of private equity on public corporations and capital markets, which brings with it

- increasing pressure to deliver even more elevated and unsustainable returns,

- a shrinking market for both public equities and venture capital - genuine capital, investment in startups with jobs, relative to the buyouts.

In the UK, where the funds are biggest and most active, equity market capitalisation shrank by a net £46.9bn in the first half of 2006 and has not grown since the last quarter of 2004. It has been estimated that at the current rate of growth the private equity sector in the UK would soon become larger than the stock market. We're clearly no longer dealing here with something which can be plausibly described as "alternative assets", but instead with investment that threatens to become the dominant mode, and is already exercising a dominant influence.

Second, the impact of potential private equity takeovers on management of publicly held companies, which try (and generally fail) to fight a takeover by behaving like… a private equity owner by slashing costs and implementing mass layoffs. The slide shows what happened when the Australian retailer Coles Mayer tried to repel a private equity bid by eliminating 2,500 jobs to demonstrate to shareholders that it was serious about "delivering value". The tactic invariably fails - private equity gets them, and more layoffs can be expected.

In sum, the global result of the buyout boom is that short-termism is institutionalised, and that is bad for companies, for workers, and for society as a whole, as well as taking us away from the goals of the Lisbon program.

Since the report was prepared, we've seen an even faster acceleration in the growth and the scale of the funds, in Europe and globally.

In 2006 private equity funds spent over USD 725 billion buying out companies – an amount equivalent to buying the national economy of the Netherlands, or the economies of Argentina, Poland and South Africa combined - with billions of dollars to spare.

In his presentation for the launch of the report in March Poul Rasmussen stated that implementing the Lisbon program would require more than 1 trillion euros. Buyout funds today can potentially mobilise in excess of *2 trillion* US dollars in purchasing power. Apply this leverage to the food sector and you get a private equity shopping spree with a basket deep and wide enough for 22 Unilevers, or 31 British American Tobaccos (BATs), or 38 McDonald's or 47 InBevs at their current market value.

Another development which has surpassed the developments described so well in the report is the growth of buyout debt to the point that the 2 + 20 model - 2% in fees, 20% equity to 80% debt ratio - which had served as a model is no longer an adequate description of what is really happening.

In fact ***the equity to debt ratio has become infinitely elastic*** through new fees, dividend recapitalisations and other creative accounting devices. For example, in 2001 the European private equity firm, Permira, put €450 million into a deal to buy the German chemical company Cognis for €2.5 billion. In the year prior to this takeover, Cognis had an after-tax profit of €109 million. Following its takeover by Permira and a round of dividend recaps, Cognis was so burdened with accumulated interest payments that despite rising sales it registered a loss of €136 million in 2006. The company has begun laying off workers as it heads for possible bankruptcy. Yet Permira and Goldman Sachs have already taken €850 million out of the company.

If we look at the impact of private equity on "social cohesion" and its impact on workers, the starting point must be recognition of the fact that private equity ownership has brought about a radical transformation of management priorities. When a buyout fund takes control, management's exclusive concern is to extract maximum cash out of the companies in the quickest amount of time *regardless of the long-term impact on output, productivity and* *profitability.* This new managerial imperative is a fundamental threat to the European social model and it is not one which that model can survive.

Collective bargaining is traditionally based on the assumption that employers invest, that this investment produces gains in productivity, and that workers - through the collective power of their unions - are able to translate these gains into improved living standards and working conditions. *Because the purpose of a leveraged buyout is to extract cash through debt in the shortest possible time, private equity dissolves the link between productivity, profits and wages*, a link which unions have struggled to establish over more than a century.

Workers not only face continuous restructuring in which conventional calculations of productivity and profit are turned on their head. They also face invisible employers. The employer in a private equity buyout becomes invisible for the simple reason that in most countries ***private equity buyouts are not treated as a change in ownership affecting industrial relations.*** European Union regulations also fail to recognise and enforce employer responsibility in this regard. The Acquired Rights Directive, which is intended to ensure continuity of employment terms and conditions in the event of a takeover, does not apply in the event of a wholesale transfer of share ownership.

This has far-reaching consequences for unions, since the absence of any legal recognition of a change in ownership allows private equity firms to evade responsibility *as an employer* in the collective bargaining process. This exclusion shields a group of investors who are among the world's largest employers. The top ten buyout funds globally each employ more workers overseas and/or have greater foreign assets than the top ten non-financial TNCs traditionally ranked by the United Nations' UNCTAD. The Blackstone Group, for example, owns companies employing over 380,000 workers worldwide, yet claims to have only 750 employees! So a group of the world's leading employers now inhabits a parallel universe where many key aspects of industrial legislation do not apply, and this has to be remedied.

In conclusion, I want to look at what these developments mean in terms of the kind of legal or regulatory changes we as unions are demanding:

- in the first instance, we think it essential to render the buyout fund as an employer visible, accessible and legally responsible for collective bargaining. In the EU this means amending the Acquired Rights Directive to take account of a wholesale transfer of share ownership in the context of the sale of a business. In this context, we need greater disclosure and transparency at all levels of the buyout business. Transparency is essential not only to shed light on the activities of the funds as a whole, but to permit public scrutiny of their financial operations at the level of the individual companies they buy and sell. We have seen, in the example given in the PES report of the Linde/Kion deal, how disclosure of the business plans *prior to the takeover* was a key element in halting the immediate stripping of company assets and securing employment guarantees. That is the single example of this type that I am aware of. Enforced transparency is therefore an essential condition for blocking the kind of wholesale financial looting which happens when the boss is a buyout fund.

- second, establish in European law the right of workers to take solidarity action within and across borders as a necessary self-defence mechanism in response to the free movement of capital across frontiers

- third, increase regulatory oversight in light of the heightened systemic risk generated by the growth of the junk bonds and other high-risk debt-based instruments which are funding the buyouts. The European Central Bank should be required to make a quarterly or monthly report on the overall exposure of their respective banking systems to leveraged buyout-related risks.

- eliminate the tax subsidies which are at the heart of the buyout business. Minimising or eliminating corporate tax is a core element of the leveraged buyout which leaves other companies and society as a whole to fund the deficit. The two core issues here are,

- first, the treatment of cash flows within the acquired companies. Current tax law in most countries allows companies to deduct from their corporate taxes interest payments on corporate debt, while payments to equity holders generally cannot be deducted. This regulatory subsidy should be reduced or eliminated entirely when company debt levels reach a specified level.

- second, tax treatment of the gains on carried interest held by general partners of private equity funds, i.e. the fund managers, which are generally taxed at the much lower capital gains rate rather than as income. This too urgently needs to change.

These kinds of tax subsidies, together with offshoring, mean that private equity buyouts are assaulting public revenue at a time when governments increasingly claim they face a revenue shortfall for essential public services. What is the future of public spending for health, education and pensions, not to speak of research and development - all of which are central to the Lisbon goals - if funds wielding hundreds of billions in buyout power funds pay little or nothing in taxes?

While it is true that tax policy in the EU is a matter for the individual member states, given the enormous growth of the funds and the risks to the entire financial system I believe that the tax issue should be seen as an integral part of the problem of systemic risk.

The close correlation between the activity of the funds and favourable changes in tax law and financial market regulations clearly demonstrates that the growth of the 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 by a well organised investor lobby. This is where our friend Commissioner McCreevy comes in. Political action built the buyout business, and political action can regulate it and put on the brakes.

In the final analysis, as I've tried to show, it is the drive for superprofits which is fuelling the buyout boom - if 25% is not enough, where will it end? The larger funds are already delivering 40%, and the costs to society are enormous and unsustainable. Regulation ultimately has to address this pressure for destructive and unsustainable rates of return and find ways to channel financial resources into productive, long-term investment which can benefit society as a whole if we are to have any chance of attaining our goals.