Labour and the Locusts: Private Equity's Impact on the Economy and the Labour Market

Seventh British-German Trades Union Forum

Manchester

16–17 July 2008

Executive Summary

- The main purpose of this year's German–British trade union forum was to address the emerging challenges posed by new financial actors, such as private equity and hedge funds. Key topics included the ownership structure, lack of public disclosure and management strategies adopted to meet the new demands of capital markets.

- Most of the discussion addressed the unique challenges posed by private equity funds. The ownership structure and legal status of private equity funds bestow unique financial power, combining tax concessions with no public disclosure.
  - Private equity funds are limited companies, meaning they have no legal obligation to disclose their balance sheets.
  - The finite life of such funds (10 years) means private equity funds normally aim to dispose of the purchased company within a timeframe of 3 to 5 years.
  - Private equity uses a *point concept of value*: the primary aim is to make the firm most profitable just before it is relisted on public equity markets.
  - In many ways this strategy prevents long-term investment.

- The structure of fees benefits private equity General Partners, even though they take a minimal stake in the fund. The term '2 and 20' refers to the 2 per cent annual management fee private equity General Partners charge and the 20 per cent share of the profit they receive from investments.
  - General Partners (GP) typically contribute 2 per cent to the total equity and Limited Partners (LP) provide the rest.
  - GPs charge LPs a management fee of around 1.5–2.5 per cent of the total value of the fund, regardless of performance.

  - When profits from investments exceed a predetermined 'hurdle rate' (usually 5 per cent) the remaining profits are divided so that GPs get 20 per cent (called 'carried interest') and LPs receive the remaining 80 per cent.
  - Academic research shows that PE funds often earn more from fees than from the 20 per cent 'carried interest'.

- The excessive leveraging used by private equity funds is based on their business model which relies on a 70/30 debt–equity split. Typically, a corporation uses a 30/70 debt–equity ratio to fund investment. This excessive leveraging has been a key factor in the current global financial crisis and therefore needs to be addressed through regulatory reform.

- The rise of private equity funds in Germany has happened very rapidly over the past few years. Their arrival has created new corporate governance challenges and has contributed to the broader decline of the Rhineland model. Private equity funds took advantage of key changes in the direction and practices of German banks to engage in highly leveraged buy-outs. These activities are relevant to trade unions because private equity buy-outs have negatively impacted employee participation via works councils and supervisory boards.
- In the UK the private equity industry poses new challenges to trade unions which must respond by maximizing opportunities to engage in public and political debate whilst monitoring the impact of private equity on firms. The practices of private equity funds demonstrate how ineffective are the principles of 'enlightened shareholder value' – which believes that it is in the shareholders' economic interest to ensure that management treats employees well – in today's market conditions.

- The purchase of Germany's FTE Automotive by private equity firms HG Capital (GB) and PAI Partners demonstrates many of the negative outcomes attendant upon being owned by a private equity fund. First, the company's balance sheet was loaded with the debt used to finance the buy-out. Management used operating cash flow to repay the debt, leading to an absolute decline in investment for research and development and new capital equipment. The workforce faced longer working hours and abolition of Christmas and holiday pay, and 250 production jobs were moved to Eastern Europe.
  - This case shows that, in the German context, trade unions need to focus on implementing codetermination within companies as well as being involved in divestments and changes in company structure. Works council members need to have influence over the sale of the company. There should be stronger employee participation rights and a focus on demands for workers' share of the profits when firms owned by private equity are refloated on the stock exchange.

- In the UK, CVC/Permira's acquisition of the Automobile Association (AA) led to the GMB Union being delegitimized. The new management achieved this by stopping automatic payment of dues and preventing GMB representatives from coming on site. Forced overtime, electronic monitoring and dubious redundancy packages were some of the tactics used by the private equity managers. In the end the workforce was cut by 3,400, or one third.
  - More importantly, the GMB used media campaigns and headline grabbing direct action protests to highlight the worsening conditions for ordinary workers compared to the enrichment of the private equity partners overseeing the firm.

- Considerable attention was given to developing an array of national policy levers that would address worker's rights, transparency, tax reform and explicit regulation for the private equity industry.
  - *Transparency* – the benchmark for the level of transparency should be that of a publicly listed company, especially if the firm is of similar size or was previously a PLC. Private equity funds themselves should also be required to publish details of their partnerships and the details of the portfolios they manage. Detailed information is an important currency in markets and guarantees a more accurate picture of private equity performance and the level of risk it is exposed to. Information on Limited Partners in private equity funds needs to be disclosed as well – equivalent to a list of shareholders in a public company. Such information would provide a clearer picture of the level of investment and performance outcomes of the industry. A greater degree of disclosure would allow for the better monitoring of systemic risks. Finally, just as directors' pay in a PLC is public knowledge, so too should private equity General Partners disclose their remuneration packages to ensure parity of transparency between public and private equity markets.
  - *Workers' rights* – potential policy levers to better represent worker's rights focused on ways of including employees in both the pre- and post–buy-out processes. In Germany, trade unions and works councils need to work within the current codetermination and co-management systems to ensure stronger rights for employee participation in the pre–buy-out process. In the UK, workers need to be consulted at the pre-takeover stage in order to ensure adequate compensation and protection, especially in highly leveraged deals.
  - *Taxation* – the private equity industry enjoys numerous tax benefits both for business practices and on personal earnings from investments. Tax rules for corporate debt need to be reformed so that leveraged buy-outs no longer enjoy generous tax concessions. Trade unions must work towards abolishing this tax relief on debt without damaging the advantages of investment for growth, and for research and development. The capital gains tax status enjoyed by General Partners must be reformed to ensure fair and equal treatment for all. General Partners often invest as little as 1.5–2 per cent – in the case of large-cap funds – and receive a disproportionate amount of the profits relative to their initial investment – 20 per cent of profits over the hurdle rate and after fees. These gains are taxed as capital gains rather than income. Moreover, the 2 per cent management fee charged by the fund is not taxed at all even if it is transferred back to GPs as income when the fund closes. Taxation of General Partners should be the same as in other segments of the financial services sector. Gains from 'carried interest' should be taxed as a performance bonus, not as capital gains.
  - *Regulation* – policy prescriptions for reform should advocate a specific regulatory framework for the private equity industry. Currently, different components of private equity funds' activities are regulated. For example, the pension funds that represent the largest source of funds, as well as the banks which provide the credit, are regulated independently, while private equity has no direct regulatory supervision. Designing a regulatory framework for the private equity industry should impose disclosure requirements on funds and the firms they own. Also, new regulations should safeguard against risky leveraging or the use of so-called 'cov-lite loans' (see below). Such measures would greatly reduce future risks to the financial system.

- Trade unions are developing a coordinated approach in political campaigns to turn the public eye towards the private equity industry. Trade unions in both Germany and Britain can benefit from additional forums – such as this year's Anglo-German Trade Union Forum – which bring together different people working on capital market strategy. Such events afford an opportunity to share information on the current activities of private equity and new strategies for engaging with this industry. Also, this provides for important knowledge transfer between participants concerning the technical components of financial markets.
  - At the trade union level new efforts to create a comprehensive capital stewardship programme and engaging with the management of pension funds can counteract private equity's activities.
  - The European Union offers a new avenue for effective policy levers to address the challenges posed by new financial actors. EU-level policy may have a greater chance of success than domestic avenues, especially with a coordinated political campaign by the trade unions.

- The concluding remarks at this year's Forum addressed the rapidly changing economic conditions and the potential consequences for trade union strategies to deal with the private equity industry – the period of cheap credit and excess liquidity of the past seven years is over.
  - With economic conditions so altered because of the global credit crunch, trade unions have a unique opportunity to argue that failing to regulate the private equity industry may prolong or worsen the current financial market crisis

For more information please contact:

Anglo-German Foundation/Deutsch-Britische Stiftung
Ray Cunningham
34 Belgrave Square
London SW1X 8DZ, UK
Tel +44 (0)20 7823 1123
Fax +44 (0)20 7823 2324
Email rc@agf.org.uk
Website: www.agf.org.uk

Friedrich-Ebert-Stiftung
Karl-Heinz Spiegel
London Office
Office 312
The Chandlery
50 Westminster Bridge Road
London SE1 7QY
Tel: +44 (0)20 7721 8745
Fax: +44 (0)20 7721 8746
Email: feslondon@feslondon.org.uk
Website: www.feslondon.org.uk/index.htm

Hans-Böckler Stiftung
Nikolaus Simon
Geschäftsführung
Hans-Böckler-Stiftung
Hans-Böckler-Straße 39
40476 Düsseldorf
Tel: +44 (0)211 7778 153/4
Fax: +44 (0)211 7778 256
Email: Nikolaus-Simon@boeckler.de
Website: www.boeckler.de

Anglo-German Foundation/Deutsche-Britische Stiftung

The Anglo-German Foundation contributes to the policy process in Britain and Germany by funding comparative research on economic, environmental and social issues and by organising and supporting conferences, seminars, lectures and publications which encourage the exchange of knowledge, ideas and best practice, both between the two countries and between researchers and practitioners.

Friedrich-Ebert-Stiftung (FES)

The Friedrich-Ebert-Stiftung, founded in 1925 as a political legacy of Germany's first democratically elected president, Friedrich Ebert, is a non-profit making, political public-interest institution committed to the principles and basic values of social democracy in its educational and policy-orientated work.

Hans-Böckler Stiftung

The Hans-Böckler Stiftung is an institute of the German Trade Union Federation (DGB) which promotes co-determination, research and studies. In all its fields of activity it is committed to co-determination as a creative principle of democratic societies. It promotes this concept, supports mandate holders in co-determination positions and advocates the furthering of co-determination rights.