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The impact of private equity on European companies and workers: key issues and a review of the evidence

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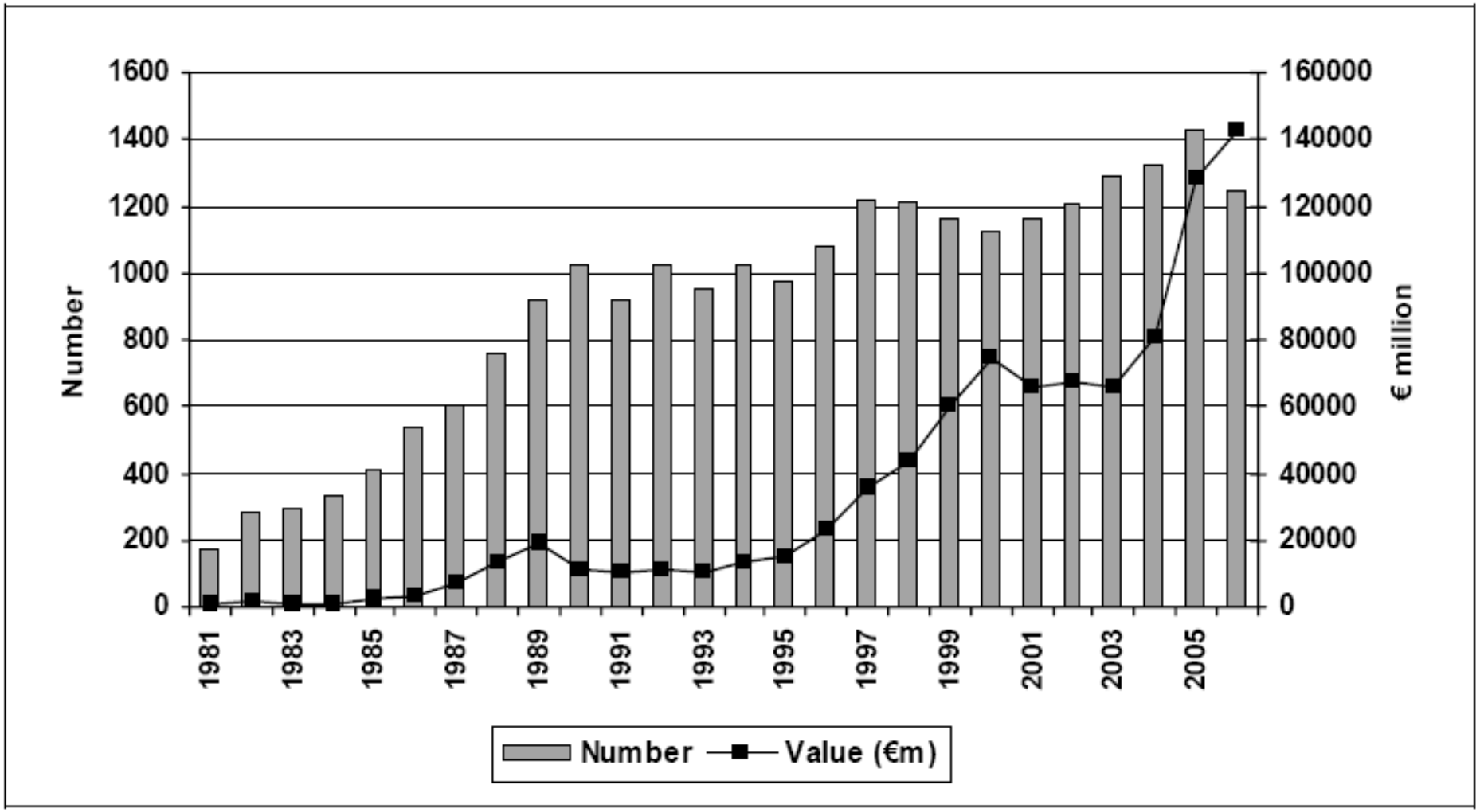
Overview

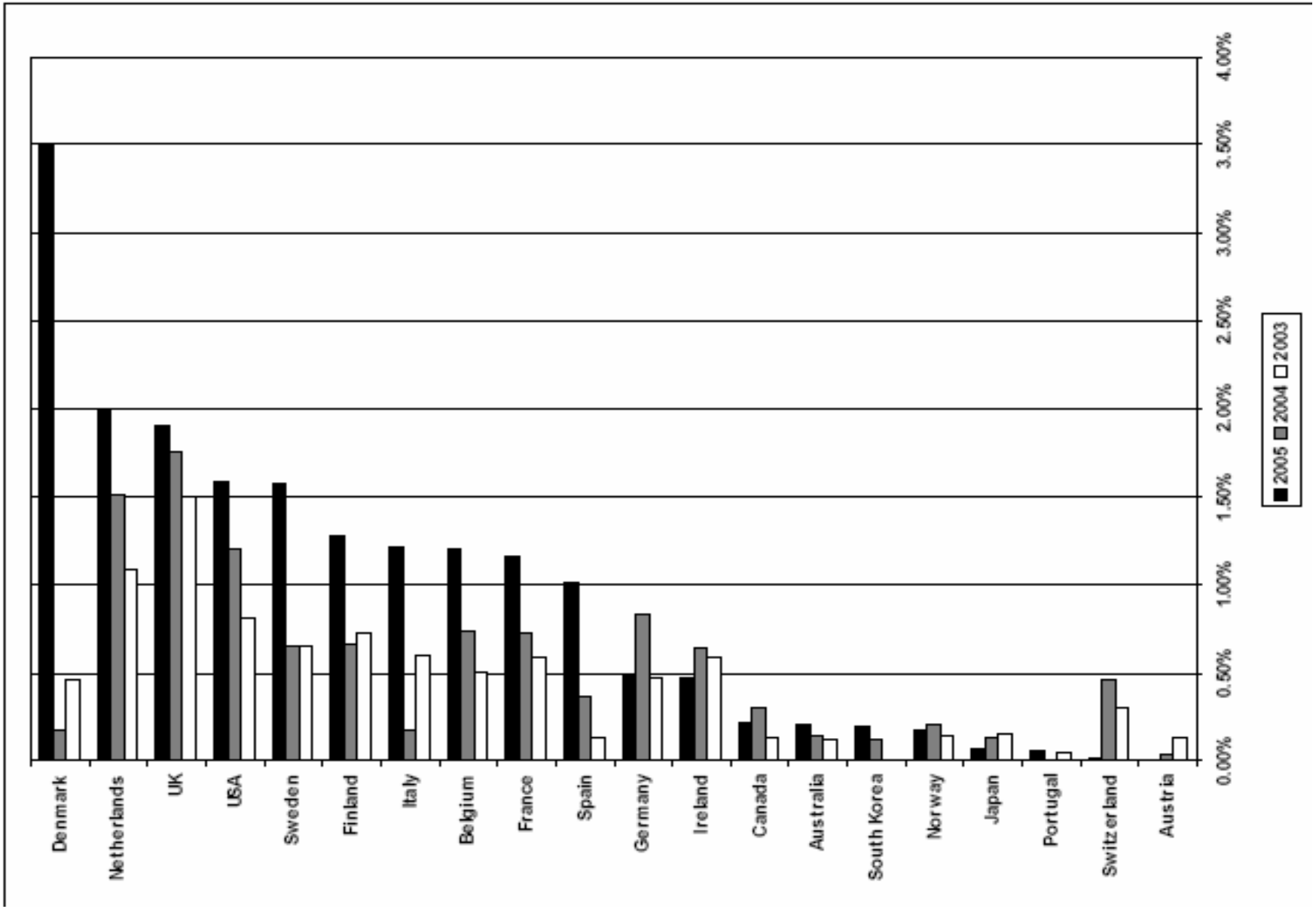
- The rise of PE – the basic facts
- The PE business model – how does it work?
- Some fundamental problems with the data and research approaches
- Issues of concern for European workers and companies
- Review of the limited evidence available
- Preliminary assessment and conclusions

Huge expansion of deal numbers and volumes with some cyclicality

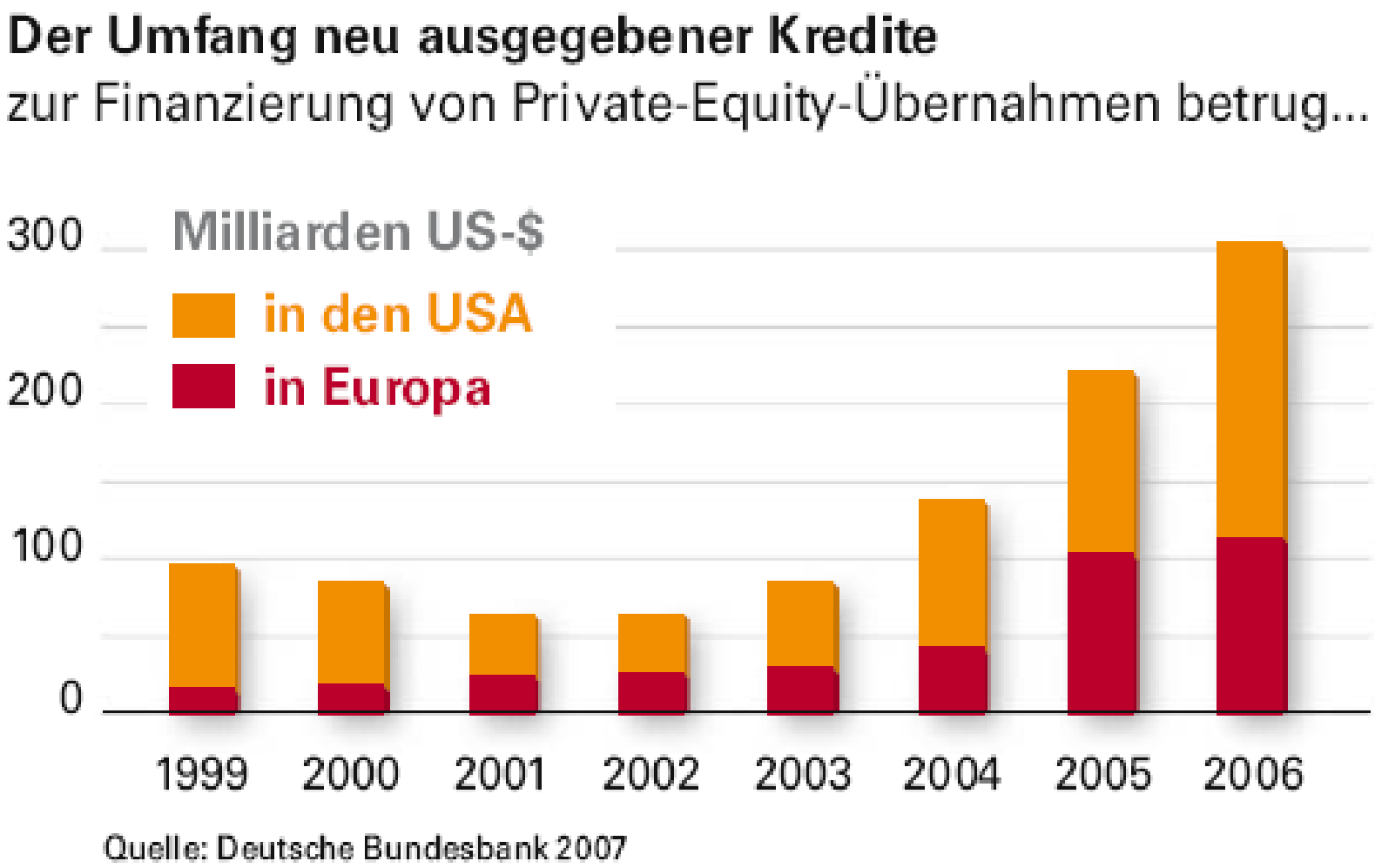
Figure 2. Trends of Buy-outs/Buy-ins in Western Europe



MBOs/MBIs as a % GDP

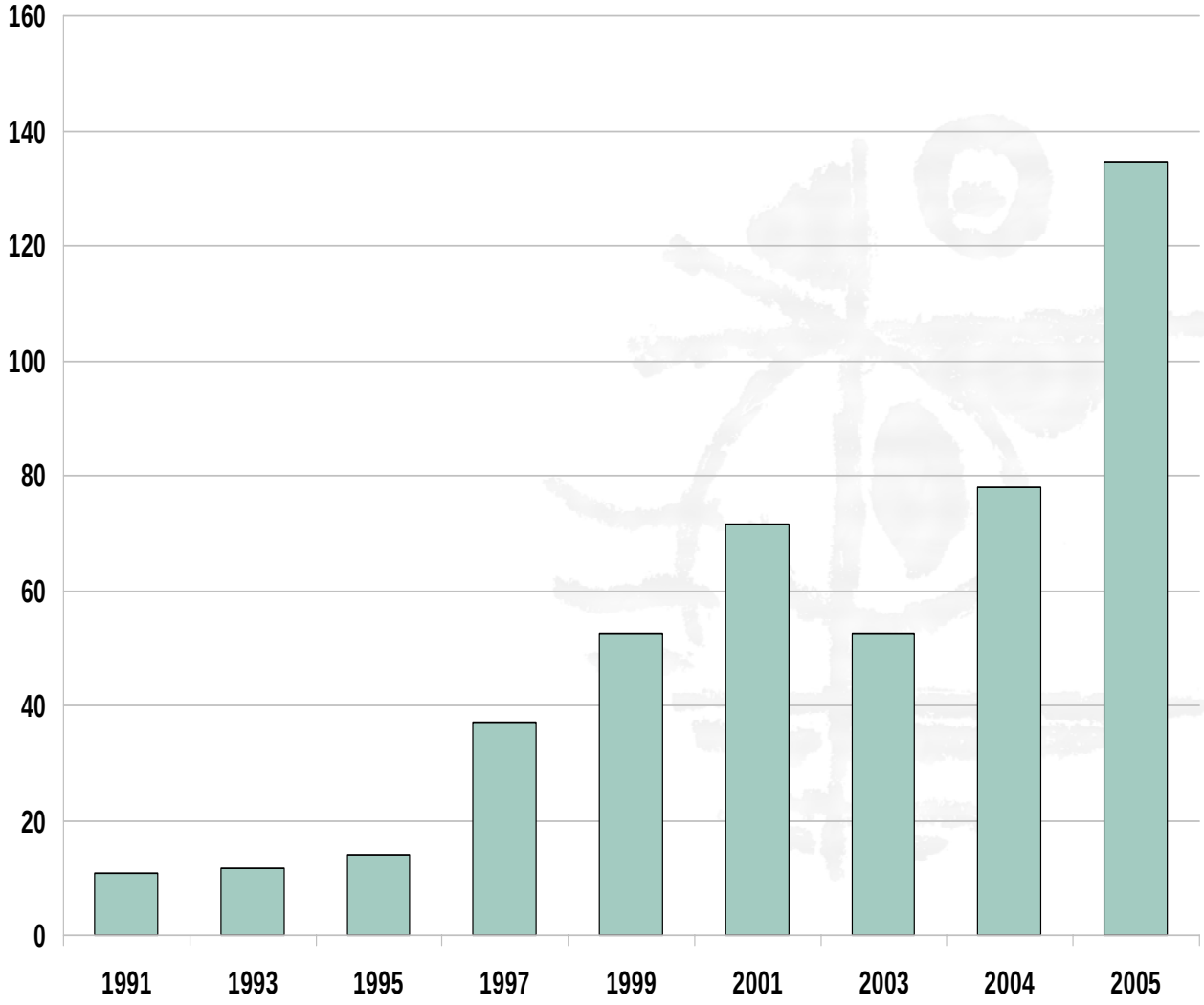


Cyclicality but huge expansion of lending for PE takeovers in USA and Europe (USD bn)



Source: Boecklerimpulse 15/07, Hans-Boeckler Stiftung

Value of invested capital abroad by collective investment funds 1991-2005 (bn USD)



UNCTAD World Investment Report 2006 and 2007

Table I.3. Cross-border M&As by private equity funds and other funds, 1987-2006
(Number of deals and value)

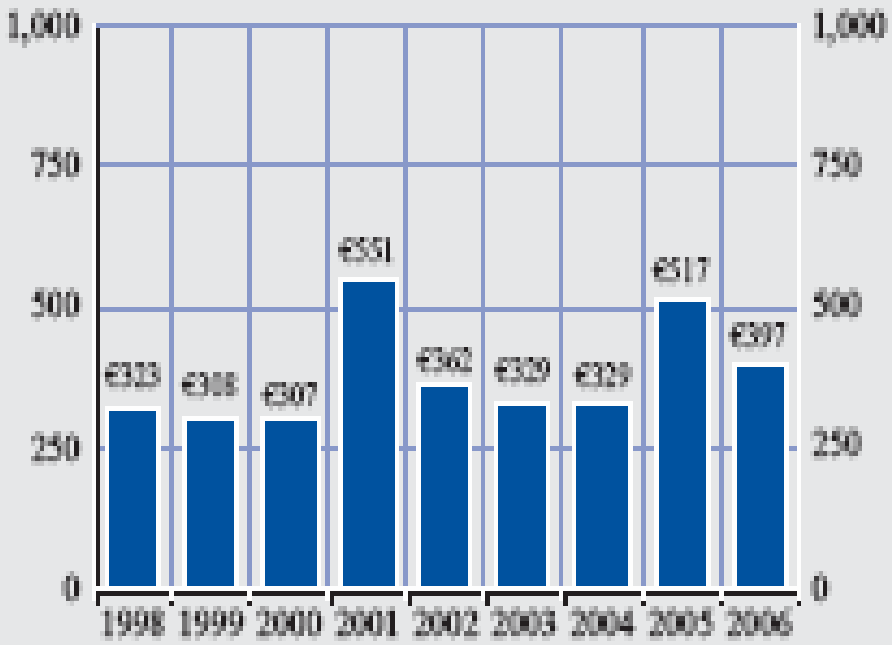
Year	Number of deals		Value	
	Number	Share in total (%)	$ billion	Share in total (%)
1987	43	5.0	4.6	6.1
1988	59	4.0	5.2	4.5
1989	105	4.8	8.2	5.9
1990	149	6.0	22.1	14.7
1991	225	7.9	10.7	13.2
1992	240	8.8	16.8	21.3
1993	253	8.9	11.7	14.1
1994	330	9.4	12.2	9.6
1995	362	8.5	13.9	7.5
1996	390	8.5	32.4	14.3
1997	415	8.3	37.0	12.1
1998	393	7.0	46.9	8.8
1999	567	8.1	52.7	6.9
2000	636	8.1	58.1	5.1
2001	545	9.0	71.4	12.0
2002	478	10.6	43.8	11.8
2003	649	14.2	52.5	17.7
2004	773	15.1	83.7	22.0
2005	889	14.5	134.6	18.8
2006	889	12.4	158.1	18.0

Source: UNCTAD cross-border M&As database.
Note: Private equity funds as well as other funds such as hedge funds are included. They are defined here to include funds managed by firms in the following industries: investment advice, investment offices not elsewhere classified, management investment offices and investors not elsewhere classified.

Large target companies and cyclical price movements

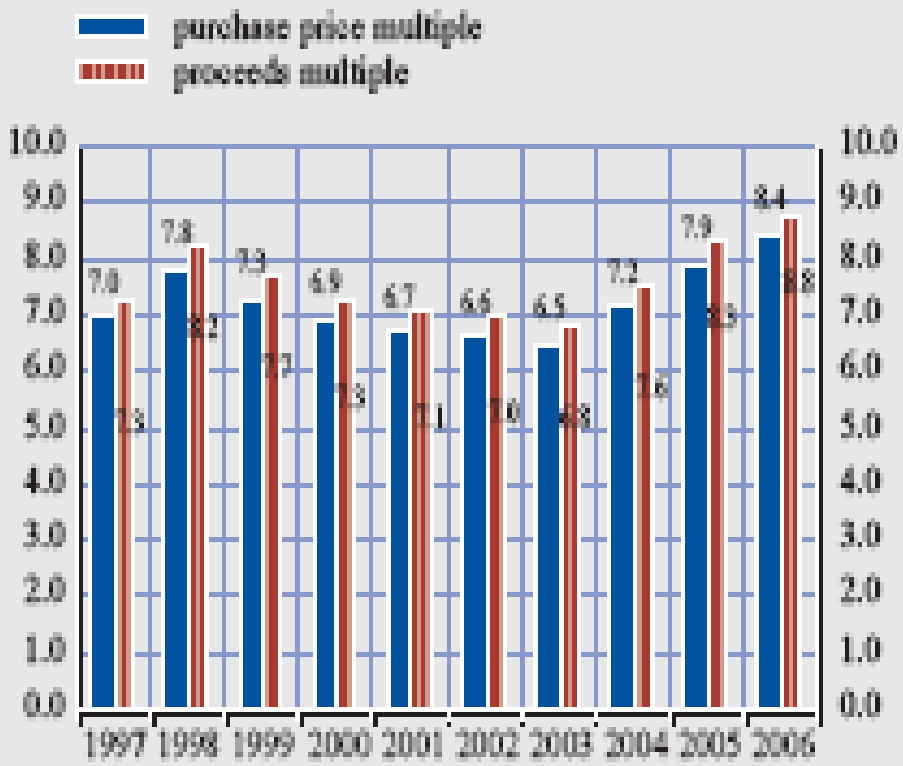
Chart E Average deal size of LBO

(EUR millions)



Source: Standard and Poor's.

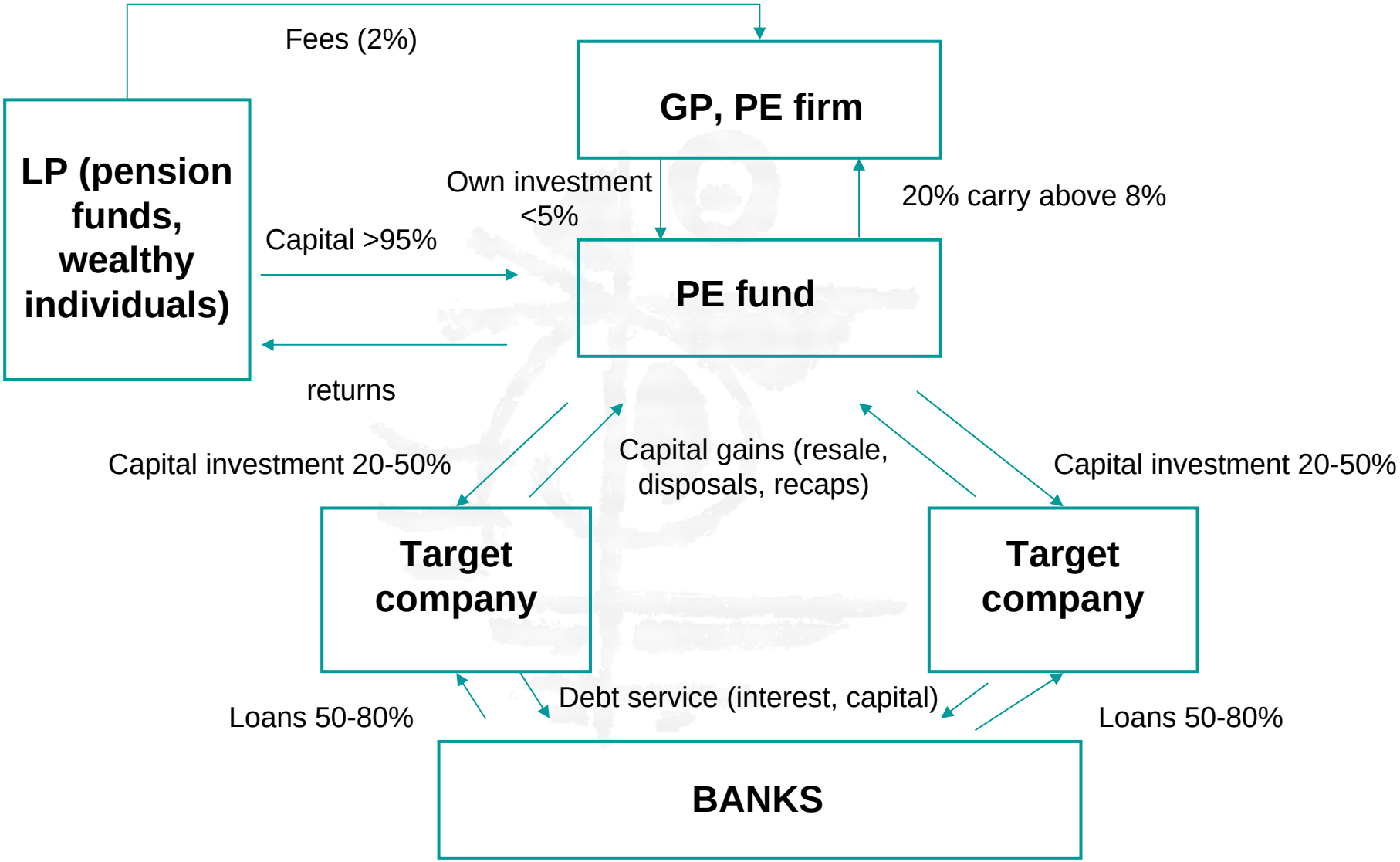
Chart F Purchase and total proceeds multiples



Source: Standard and Poor's.
Note: Total proceeds include senior debt, subordinated debt, equity and other debt.

Source: ECB 2007

How PE functions – relations with counterparties



Author's summary of information in literature

Characteristics of business model

Capital gains model (not longer-term returns): purchase-restructure-sell

- **Returns from sales price > purchase price**
- **Dividend recapitalisations**
- **Sales of assets (in extreme cases: asset stripping)**

Illiquid (average ownership of target company ca. 5 yrs)

High risk investments (illiquidity plus substantial leverage)

Sensitive to stock market developments and cost of external capital (cyclical)

Focus on target companies with assets that can be used as collateral (or sold) and steady cash flow

Incentivisation of management

As 'outsiders' little obligation to maintain 'implicit contracts' with stakeholders, especially workers

Four possible sources of 'higher returns'

- 1. Genuine improvements in performance of firms (better management, new investment, changed strategies, higher 'technical' productivity, etc.)
- 2. Transfer from workers (cuts in employment, increased intensity of work, cuts in pay and worsened working conditions)
- 3. Transfer from the government (financial engineering of the company, increased debt, transfer of profits abroad etc. reduces tax revenues to government)
- 4. Transfer from other 'capitalists' (three basic types: previous owners are underpaid, investors in the PE fund are 'exploited' by general partner, subsequent buyers are overcharged)
- 1 = value creation 2-4 = value appropriation/extraction
- What is the mix? -> empirical question

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Some fundamental problems with the data and research approaches

- Data on PE-owned companies not freely available ('taken private')
- Surveys conducted or commissioned by PE trade associations (even academic ones – Nottingham): essentially no 'clean' public data
- Limited response rate (EVCA: 10%) to surveys (representativity?) and use of estimates
- Survivorship bias (clearly unrepresentative)
- What is the counterfactual? (what benchmark? PE companies not randomly selected)
- Definitional issues (e.g. inclusion of venture capital)
- Extrapolating from micro to macro level
- PE universe very diverse (averages may tell us little)

Evidence – preliminary remark

We do not have the data to definitively answer the 'charges' against private equity one way or the other:

Make reference to:

- **Academic reports**
- **Surveys by financial authorities**
- **Trade union publications**
- **Case study evidence**

Issues of concern for European workers and companies

Cuts in employment and pay, increased intensity of work and worsened working conditions in target companies in order to generate higher returns to owners, impact on information and consultation rights and collective bargaining

Taxation carried interest. deductibility of debt PE firms and offshore transactions (reduce tax revenues to government and raise inequality)

Transparency and reporting (loss of valuable data when firms taken private)

Leverage, risk of insolvency (micro) and financial stability (macro)

Workers' pension funds (returns, risk)

Short-termism (impact on long-term investment in both PE and non-PE companies

Conflicts of interest and market abuse

Key issue: Is value genuinely added?

Focus of numerous studies:

Some focus merely on share price/sales price at firm level:

- **May reflect 'picking winners', hoodwinking buyers etc.**
- **But Cao/Lerner (2007) find the longer-term performance of former LBOs 'outperform other IPOs and the stock market as a whole'**

Cumming/Siegel/Wright review productivity studies at plant level: 'LBOs and especially MBO enhance performance and have a salient effect on work practices' (17)

EP commissioned study provides evidence of above-average growth and performance

<u>Conclusion</u>: seems likely that PE on average adds value to 'the firm' (i.e. capital owners) especially in underperforming firms but extent to which genuine value creation rather than value appropriation not clear

Employment losses?

Industry-commissioned studies (EVCA 2005, BVCA 2006) methodologically problematic ('worthless' Hall 2007)

OECD commissioned study (Wright et al. 2007) reviews other academic studies and reports 'mixed' results.

Amess/Wright 2006 show for the UK an interesting distinction between MBOs and MBIs (PE can be both, but more the latter). MBOs are shown to raise employment (exploiting strategic opportunities), MBIs to cut employment (restructuring, breaking implicit contracts). Effects small (+0.5% and -0.8% p.a.)

IUF Private Equity Buyout Watch Update provides company-by-company cases, often including large employment cuts (although often linked to divestment)

<u>Conclusion</u>: Numerous studies with a mixed picture. Distribution of individual cases almost certainly very wide. Overall, employment losses seem likely on average, especially where management is changed. To some extent though the jobs in these firms may not have been sustainable. In any case tells us nothing about macro employment levels (but re-employment likely to be at worse pay/conditions). Huge 'counterfactual' problems. In addition to above 'fundamental' data issues, problem of differentiating organic from acquisition/divestment-driven growth

Wage cuts and working conditions?

Similar picture to 'employment' above

However, Amess/Wright 2006 show negative wage effects for BOTH MBOs and MBIs compared with benchmarks.

For Germany case studies have been conducted by the Hans-Boeckler Foundation (HBS) and Kaeserer (2007). The findings of the former are mixed, the latter more positive on both employment and wages. However, these cases cannot claim representativity.

There is little evidence on working conditions. Wright et al (2007) report evidence for UK and NL that HRM practices modernised working practices (flatter hierarchies, more 'empowerment' in MBO firms) – but limited sample, PE financed research

The ‘vanishing employer’ – workers’ rights and participation

Little systematic research here.

The EVCA notes that it is bound by national industrial relations and codetermination legislation. However, conformity with the law requires enforcement and there is still space for a substantial deterioration in actual standards from workers’ point of view.

The HBS case studies are particularly critical of issues regarding worker representation and codetermination rights. The IUF Private Equity Buyout Watch Update provides company-by-company cases and repeatedly identifies cases where trade unions, collective bargaining structures and worker participation is disregarded by new owners. More broadly, the ‘vanishing employer’ is a frequent complaint of trade unions in the context of LBOs by PE (e.g. TUC 2007).

Where trade unions have a strong organisation position (and even use takeover to increase membership) and company prospects are good, they can bargain effectively with incoming PE owners. Even for turnarounds PE may see workers representatives as a positive resource (*Mitbestimmung* 06/2006).

Gap identified in the Transfer of Undertakings Directive that should ensure workers rights in the case of takeovers, but from which PE is exempt.

Taxation – is value appropriated at the expense of public finance?

PE business model clearly tailored to reducing tax liability.

In a number of areas taxation systems seem to privilege PE model in a discriminatory way:

- **Much income of GPs taxed as capital gains at much lower rates that earned income (e.g. 10% vs. 40% in UK)**
- **Interest payments on bank loans tax deductible (privileging of debt over equity)**
- **Use of non-domiciliation and tax havens**
- **In DE PE is not considered a business at all at does not pay Gewerbesteuer.**

Government studies (e.g. DK, UK, DE) have calculated the impact on public finances of PE takeovers and rgulatory action has already been taken

PE representatives themselves have recognised that lack of willingness to pay tax ('less than my cleaning lady') is an image issue

Rates of return (to whom?)

Complex comparisons because LPs have to hold funds 'on standby' prior to investment in target company, returns from PE are 'lumpy' and allowance should be made for risk and illiquidity, Also reporting and survivorship bias problems.

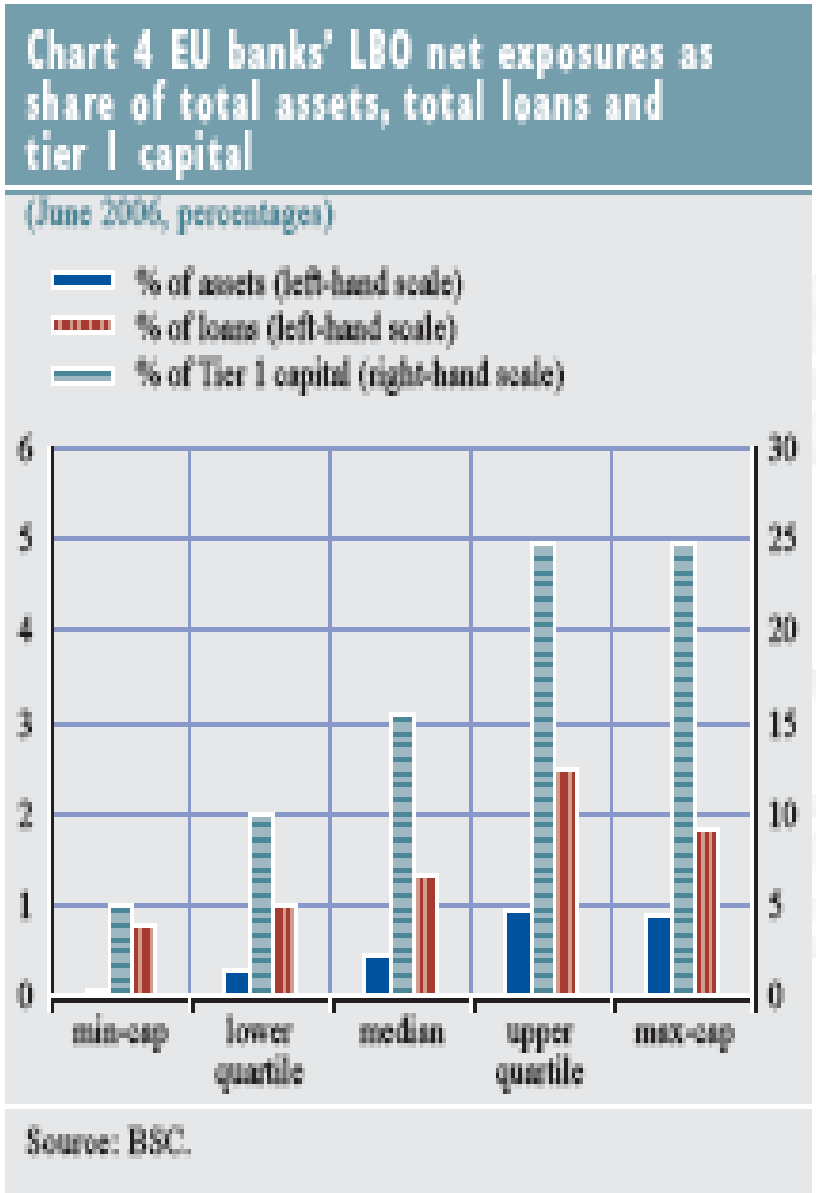
EVCA: All PE 10.8% (VC 5.5%, BO 14.4%) funds since 1980, net (press release June 2007)

Wright et al 2007 cite several studies suggesting returns are relatively high

Numerous academic studies (Kaplan and Schoar 2005, Dillich and Kaserer 2007, EP-commissioned study 2007) suggest strongly that overall net returns are below stock market average (negative alpha), even if gross returns outperform stockmarket (high fees and carry)

<u>Conclusion</u>: GPs of successful PE firms earn fantastic returns, LPs of successful PE firms above-average returns. Variation in returns is much higher than with other forms of investment. On average though net returns almost certainly lose to and even probably below stock-market averages despite higher illiquidity and risk.

Banks' exposure and systemic risk



ECB 2007

'the relatively low proportion of LBO-linked assets compared with total balance sheet sizes (or even own funds) seems to show that the potential for a severe market downturn to have a material impact on their financial accounts is still rather limited.'

But:

- Sub-prime crisis (contagion)
- Rising interest rates
- Covenant lite problems

'…awareness of the risks and vulnerabilities in these rapidly growing markets [LBO] should nevertheless be increased.' (ECB)

Conclusion: PE fund insolvency a risk at micro level, but not apparent that systemic risk from PE is large relative to other sources, but securitisation and lack of transparency call for caution and further research (ECB, FSA, EP report)

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Short-termism and investment at the micro and macro levels

Critique	Counterargument
Five year holding period militates against long-term investment	Horizons longer than public companies driven by 1/4ly reports, and PE needs to sell a company with prospects
Managerial 'growth' focus is macroeconomically desirable even if less profitable for shareholders	Managerial 'growth' focus is wasteful and inefficient
PE sucks out cash from the company, especially via dividend recaps, restricting internal finance	PE provides capital for starved companies; reducing free cash flow ensures investment more efficient. Recaps merely an issue of timing.
Pressure of hostile takeovers forces short-termism also on public companies	Managers need to be kept on their toes by the threat of takeover
At macro level profits are rising as share of GDP but investment is falling – linked to 'financialisation'	This is related to other factors than PE.

Conclusion: Complex discussion and lack of empirical evidence – critiques certainly valid in some cases, but testing overall validity requires further work

Author's summary of arguments in the literature

Transparency and information

In most countries there is no official register of PE companies and many operate from off-shore bases. Reliance on self-regulation and registration by trade bodies considered by many critics to be insufficient. PE-owned/generated data not freely available for impartial academic assessment.

When public companies are taken private valuable information is lost to the public realm, no longer just for SMEs.

The prospectuses of PE firms have been shown to overstate benefits and underplay risks to investors (see 'returns')

<u>Conclusion</u>: The secrecy and opacity of PE firms is widely criticised, particularly as size of target companies has increased. Critique increasingly accepted by 'liberals' and some PE trade representatives who want to come out of the shadows. Consensus on this issue.

Implications for workers' pension funds

Results on net returns suggest that 'all that glisters is not gold'. From a purely financial perspective workers' pension funds should not invest substantial sums in PE unless they can be confident of gaining access to the best performing funds.

Funds should also be aware of the cyclical nature of PE and (in the current juncture) not be last to jump on the bandwagon.

Pension funds should pay close attention to fee structures on PE firms. Large funds can bargain effectively with PE who need to raise capital for successive funds.

Beyond this workers' pension funds face tricky ethical issues to the extent that PE-owned companies engage in activities that are 'unethical' or anti-worker point of view. These issues are not specific to PE, however, and pension funds need ethical standards more generally to underpin their investment strategies. Possible returns/standards trade offs (interests of pensioners and current workers) must be addressed. Large funds can influence target company behaviour.

Conflicts of interest and market abuse

Theoretically considerable opportunities for market abuse and conflicts of interest:

- **Incumbent managers may be incentivised to drive down current value of to-be-targeted company.**
- **Buyers may spread negative disinformation about target company**
- **Potential buyers may gain access to privileged information which is used for insider trading**
- **Advisers and leveraged finance providers may have dual and conflicting roles**
- **Collusion between groups of buyers in bidding**

Evidence

FSA concerned about these issues but sees little need for reform

HBS Study (Schmidt//Spindler) sees reform needs in several areas of company law to address issues

EP commissioned report finds little evidence of conflicts of interest

Wright et al report concerns by US regulators about treatment of minority shareholders and collusion between PE bidders

<u>Conclusion</u>: Given the scope for problems regulators should intensify their supervisory efforts in these areas and where necessary take effective counter measures (often not specific to PE)

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Provisional conclusions

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The PE business model, the expansion of the industry and the increasing size of firms taken private call for a transparent and open public debate. Private equity is not a purely private transaction. Data on the industry must be made publicly available and analysed scientifically and independently.

While the overall evidence is often patchy, case studies and the experiences of workers' organisations and governments suggest that PE practices are *in some cases at least* detrimental to the legitimate interests of other stakeholders.

On the other hand the evidence shows that PE performs useful restructuring tasks, resolves management difficulties.

Any regulatory activity must attempt to curb excesses and resolve problems without blocking positive role for PE.

PE activities must be seen in context (e.g. reflections on the way *publicly listed* companies are regulated). At the same time workers' concerns about PE need to be seen in the wider context of rising inequality and pressures on workers from globalisation and other elements of financialisation (hedge funds, activist investors).

A strengthening of trade unions and workers' representatives at the firm level and more generally is an important counterweight to negative trends.

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