Private Equity – what response from the trades unions?

Until a few months ago 'private equity' meant little to anybody other than economists or investors. However, the prospect of take-overs by PE firms of major companies such as Sainsbury's and Boots has prompted a discussion in the media about the nature of the private equity (PE) phenomenon and the implications for the economy overall. At the same time the GMB's campaign highlighting the impact of private equity take-overs on workers has helped to put these companies on the defensive, protesting against being labeled as "asset strippers". GMB members in the Automobile Association, Birds Eye, and National Car Parks, have all suffered high levels of job cuts, and intensification of work, contrasting with fantastic financial rewards for small numbers of managers.

To show what reasonable people they are the British Venture Capitalists Association conceded in March that there was a 'genuine recognition' of a need for a greater level of disclosure in relation to PE-backed deals. The signatories to their initiative said they believed there would be 'real benefit' to all 'stakeholders' if a regime of more effective disclosure was introduced. Hence the BVCA has formed a working party under the chairmanship of Sir David Walker, a former chairman of the Securities and Investment Board, to draw up a voluntary code on a 'comply or explain' basis to address the transparency of the industry and levels of disclosure.

Barbarians at the Gate

PE is not a new phenomenon. In 1988 there was a great deal of publicity over the acquisition of Nabisco by a private equity company for $21 billion dollars. The event was the occasion for a book and a film: The Barbarians at the Gate. The growth of PE, however, suffered as a result of the dotcom collapse and there was little money put into the private equity market. Over the last few years, however, there has been a phenomenal increase in the scale of the PE market and the size of acquisitions. In the US for instance, in 2001 there were just three deals over $1 billion dollars and none over $10 billion. Yet in 2006 there were 57 deals over $1 billion and nine over $10 billion. The latest record acquisition was a $45 billion buy out of TXU, the Texan utility company.It is the scale of the growth in this market and the level of "leverage" (debt) used to make these acquisitions which has worried even supporters of 'the market economy'.

The Financial Services Authority report in November 2006 raised concerns as to the dangers of the level of debt associated with PE buy-outs, for the economy overall. In its assessment of the risks the FSA said:"We reached the view that it was actually pretty much inevitable that some of these private equity backed companies would actually go bust. The more debt that is inherent in a company, the more likely it is that any major change in interest rates, any major rise in interest rates, or change in the economic circumstances of the country, could actually cause that company to get into distress."In particular the levels of "excessive leverage" associated with these deals gave the FSA cause for concern.

The big increase in the amount of credit associated with PE transactions, "may not in some circumstances be entirely prudent", said the FSA with masterful understatement. So much so that "the default of a large private equity backed company or a cluster of smaller private equity back companies seems inevitable". The FSA expressed concern that in "extreme circumstances" this would have negative implications for the financial stability of the UK economy. The amount traded may "substantially exceed" the amount of underlying assets.

A common ratio for PE acquisitions is 20% equity (money raised directly by the company taking control) and 80% debt, borrowed from financial institutions. When a company is bought it is common for the new owners to take on additional debt to finance large dividends through "dividend recapitalization", enabling them to very quickly recoup a large part of their initial investment. For example KKK, Carlyle and Providence paid themselves a $250 million dividend in October 2004 a month after putting $550 million into a $4.1 billion deal for PanAmSat Corporation. This is not productive investment in plant, machinery or infrastructure. It simply burdens a company with a debt which has only one purpose – to hand over money to the PE firm.

Peter Rossman, Communications Director of the International Union of Foodworkers gave a briefing to a meeting of union sponsored MPs in the House of Commons, in which he said: “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 instance, 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.” These methods lead to the saddling of acquired companies with massive debts which threaten to sink them. Permira (which took over the AA) bought the Germany chemical company Cognis in 2001 for $2.5 billion dollars, using only $450 million of their own money. In 2000, the company had an after-tax profit of €109 million. Despite rising sales last year it lost €136 million and has begun laying off workers. Yet Permira and Goldman Sachs have taken out €850 million.

Across the Irish Channel Eircom, which was privatized in 1998 was acquired by PE consortium Valentia in 2001. Eircom paid for the loans by issuing bonds which raised its debt from 25% to 70% of the value of its assets. As a result capital expenditure by the company fell from €700 million in 2001 to €200 million in 2004, the decline undoubtedly related to the €400 million dividend it paid to Valentia.

Ratings Agency Standard and Poor’s has said that PE funds that load take over targets with huge amounts of debt to pay management fees and dividends to investors, had contributed to a decline in the credit ratings of European companies. Their report announced that the amount of debt rated as “junk” (a rating which indicated a speculative investment with some risk of not getting repaid) rose to 17.2% in 2006 as compared with 1.2% 15 years previously. (It’s interesting to note that the proportion of junk-rated debt in the USA reached 50% at the end of last year.)

Regime of Bullying

The consequence of this is that repayment of increased debt levels and dividend payments leads to increased pressure to drive down wages and cut staff. GMB members in the AA experienced this, a kind of employers’ class war regime, which led to 3,500 job cuts and a regime of bullying. The company utilized a scab ‘union’ led by a former GMB official, to de-recognize the GMB.

In Hull Birds Eye workers were made redundant when the company was taken over by a PE company.

In the case of NCP (where strike action by GMB members recently won a recognition agreement), PE firm 3i was appointed by ‘venture capitalists’ Cinven (who acquired NCP in 2005) to run the on-street business which provides parking wardens, vehicle clamping and removal services to 31 local authorities. Staff are under great pressure to ‘perform’ by issuing a certain number of parking tickets every day. 3i sold NCP to Australian Bank Maquarie in a deal which produced a profit of £245 million in just 18 months!

As Peter Rossman points out the impact of PE is not limited to the companies it acquires. “The funds have gotten so big that virtually every public listed company is now a take over target.” The response of stock market listed companies resisting a take over is usually to slash costs and staff numbers.

“A pre-bid environment hangs over the economy as a whole, meaning short-termism is institutionalised, bringing more job cuts and more attacks on wages and working conditions and more attacks on trade union rights.”

The PE industry insists that it creates value and creates jobs. However, they do not have to report in the way that listed companies do. So secretive are they that the Work Foundation, in preparing its recent report (http://www.theworkfoundation.com/Assets/PDFs/private_equity.pdf) could not get a single private equity company to disclose information on job cuts in the companies they took over.

Vulnerable to systemic shocks

The Work Foundation report confirms what Rossman says:

“PE companies are highly vulnerable to systemic shocks and changes in interest rates due to the leverage model they employ. The exponential growth of PE in recent years exposes a greater proportion of the economy to these very real risks; the potential of greater instability exists as a result.”

The FSA expresses concern about the impact of private equity on the ‘public’ markets. According to them PE firms raised more funds in the first half of 006 than firms listed on the stock market (£11 billion compared with £10.4 billion). The UK equity market capitalisation shrank by a net £46.9 billion in the first half of 006 and has not grown since the last quarter of 004, according to the FSA. Whilst the PE industry can point to some companies that have ‘grown the business’ they have taken over, even some of their supporters have said it is difficult to get an overall picture given the lack of transparency in the industry. The Work Foundation report underlines what is clearly a central feature, especially of “highly leveraged” deals: the level of exploitation of the work force is driven up and wages are depressed for the main body of the work force.

So how should the unions respond to this growth of private equity and the ‘pre-bid environment’ which Peter Rossman refers to? Industrial action is an obvious component to defend the wages, jobs and conditions of service of their members. But government policy is a factor as well. The GMB is right to demand of Gordon Brown that he end tax concessions which encourage the take over of companies by PE outfits. Why should these companies be allowed to create debt solely to provide big up-front dividends for a small coterie of managers? Why should they be allowed to invest as little as 20% of their own money, saddling a company with what may well prove to be unsustainable debts? The amount of debt being used to fund these buyouts has increased from an average of seven times earnings (of the acquired company) to over nine times in 2006.

According to the BCVA its members contributed only 5.4% of their revenues in tax for the year 2005-6. PE companies have been able to gain advantages via the tax-deductibility of interest simply by reason of the vast volumes of debt that they take on under their business model. Executives and partners in PE funds are able to gain a huge tax break by the treatment of their profits as capital gains rather than income. Compare this with the treatment of people who cannot receive many state benefits because they have the paltry sum of £16,000 or more savings!

Pensions

The Work Foundation report further highlights a couple of important issues. Firstly pensions. Members of pension schemes “would be among the major losers if the PE train ever came off the rails”. It would be interesting to know how much money in PE acquisitions comes from pension funds. The trades unions should surely campaign against pension funds risking the money of their members in “highly leveraged” take-overs.The Work Foundation says there is “a major potential conflict of interest for company managers who can see a huge personal gain for agreeing to a highly leveraged take-over.” Such transactions should be open to public scrutiny, of course.They are certainly right to say:“It cannot be allowed that a large portion of the private sector is immune from proper public oversight – especially as the risk-exposure levels involved in private equity may pose potential risk to the wider financial system.”

TUPE

Another issue they highlight relates to TUPE (Transfer of Undertakings Protection of Employment). TUPE does not apply where undertakings are transferred through share purchases. We should obviously demand that TUPE should apply to these deals.More fundamentally, what does PE tell us about the economic system under which we live? PE appears to be a means of overcoming the historical decline in the rate of profit which occurred after the end of the post-war Bretton Woods system. It is part and parcel of an international system in which most of the money that is made is from gambling on the stock markets; over 90% of which activity is unrelated to production. Making money out of money is easier than making money out of producing and selling things. What seems to be relatively new about the growth of private equity is that these ‘venture capitalists' or PE kings are prepared to saddle companies they acquire with unsustainable levels of debt for which the work force must pay the price, and service provision worsens.

Brendan Barber, TUC General Secretary, writing in the Financial Times called for rapid international action "to stop private equity providing mega-bucks for a few at the expense of the social contract that ensures at least stability and equity." He complains that companies are treated simply as "collections of assets to be bought and sold, not as social institutions or long term wealth creators." You have to ask, where has Brendan been for the last 20 years? Since when did 'public' companies place the social interests of their workers before what the Americans call the bottom line?

The probable crash/crashes that the FSA believes inevitable may lead to a big collapse in the PE market. current PE mania is the product of an economic system in which 'investment' has been in large part detached from the productive economy. "Creative destruction" may well be, says Barber, "an inevitable part of the market economy". Yet this 'creative destruction' actually destroys lives, impoverishes people, and ruthlessly exploits labour. Witness the 'creative destruction' of factories and the rush to China and other places where working conditions read like Engels writing on the condition of the English Working Classes in the 19th century. Brendan Barber says that the growth of PE is "a way of getting round the social contract at the heart of our market economies". At the heart of 'modern economies' is "a balance between the undoubted prosperity which markets deliver and measures to protect against the instability and damage that they can also wreak. That is why we expect companies to pay tax, to be transparent in the way they operate and why we regulate markets to guard against stability."

What 'social contract' is this he's talking about? It is a figment of Brendan's imagination. He is well aware of the boasting of Brown and Blair about the low tax, light regulation regime that they have arranged, and the level of tax evasion by big corporations. PE is an extreme form of profiteering which is carried out at the expense of the workforce and the service provided.

A reversal of the 'light regulation' regime would be a step in the right direction. However, instead of counter-posing the lack of transparency of PE with Public Limited Companies, the unions should be exposing the fact that PE is an extension of the globalised financial markets, the purpose of which is to make profit unrelated to productive economic activity. Instead of seeking to 'make globalization work for everyone' (an impossibility) we should be challenging 'globalization' which was not the result of some natural evolution, but of political policy and practical decisions designed to free capital from all social and political control.

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