AUSTRALIAN MANUFACTURING WORKERS' UNION

SUBMISSION TO INQUIRY INTO PRIVATE EQUITY INVESTMENT AND ITS EFFECTS ON CAPITAL MARKETS AND THE AUSTRALIAN ECONOMY

SENATE STANDING COMMITTEE ON ECONOMICS

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Introduction

1. The Australian Manufacturing Workers' Union (the AMWU) welcomes the opportunity to make a submission to the Standing Committee on Economics' inquiry into private equity investment and its effects on capital markets and the Australian economy.

2. The full name of the AMWU is the Automotive, Food, Metals, Engineering, Printing and Kindred Industries Union. The AMWU represents approximately 130,000 workers in a broad range of sectors and occupations within Australia's manufacturing industry.

3. The AMWU is also one of a number of unions with members who will be affected by the much publicised proposed private equity take over of Qantas Ltd.

4. It is the union's submission[1] that the significant increase in private equity investment creates a number of challenges for governments, working families, regulatory bodies and the taxation system of Australia.

5. The migration of private equity deals from startups or small and medium-sized companies to blue-chip public companies requires a comprehensive assessment of the economic and social benefits that may, or may not, result from private equity investment.

6. It is the AMWU's contention that private equity investment should be measured against the three pillars of sustainable development - environmental, economic and social. The Australian government must guard against short termism and promote long-term value creation, decent work and sustainable development.

[1]In preparing our submission the AMWU has, amongst other sources, relied on relevant material produced by the International Trade Union Confederation. The website for the International Trade Union Confederation is www.ituc-csi.org.

7. The AMWU supports the international unions who met in March 2007 at the OECD in Paris and issued a strong call for the activities of companies to be oriented towards long-term sustainable investment strategies that create wealth for all, and good employment opportunities for workers.

8. The meeting of unions noted that private equity firms have in a short period become owners and movers of vast pools of capital, significant sectors of the economy and of employment.

9. It is said that the share of private equity investments in the total volume of mergers and acquisitions exceeds 20% in some OECD economies. These alternative funds are highly leveraged. They are also generally exempt from many of the regulations that apply to traditional collective investment schemes, banks and insurance companies, particularly in the areas of investment and prudential rules and reporting requirements.

10. The AMWU is concerned that the very high rates of return required to finance private equity debt driven buyouts can threaten target companies' long-term interests and provision of decent employment conditions and security for employees. Rather than corporate restructuring for the purpose of shared productivity gains, some private equity firms are seeking to extract maximum value over a short period before reselling the company (or what remains of it) and banking a substantial premium.

11. Internationally, trade union experience with employment and working conditions in leverage buyout firms gives cause for alarm.

12. More broadly there is international concern that the private equity model poses risks to the stability of the international financial system and the sustainability of national economies.

Reference (a)

An Assessment of Domestic and International Trends concerning Private Equity and Its Effects on Capital Markets

13. While private equity remains a relatively small part of the Australian market, fund-raising for private equity has grown to record levels in recent years. This trend is being replicated on international markets.

14. It would appear that the growth of private equity investment domestically and internationally has been boosted by favourable tax and regulatory requirements for private companies against publicly listed companies.

15. Given the favourable tax treatment afforded to private equity investments, and the potential scope for manipulation by private equity companies to maximise tax benefits, the growth of private equity is likely to increase over the short, medium and long-term.

16. This trend raises serious issues to be dealt with by policy makers in Australia and overseas.

17. The AMWU is concerned that private equity companies must be more open and transparent. Further, regulations applying to private equity must be addressed to ensure that an artificial competitive advantage is not available to one firm over another.

18. The massive financial incentives provided to senior management as a result private equity deals raises potentially serious issues of conflict of interest and insider trading which affects the transparency and effective operation of capital markets. The incentive structures applying to senior management under private equity ownership unfairly benefits a narrow group of participants at the expense of shareholders.

19. Broader investment decisions by superannuation funds and returns to members are affected by the extremely high transaction costs associated with investment in private equity companies. Trading becomes more complex, dominated by one-off transactions; price is set by negotiation and not by the market.

20. As private equity deals proliferate, international experience suggests that the cost to investors' increases while disproportionate profits and fees accumulate to individuals and management. According to Martin Wolf the respected economic commentator of the Financial Times:

> *"the disproportionate allocation of profits creates a conflict of interest between the "general partners" who run the funds, and the "limited partners" who invest in them. The general partners have enjoyed an annual management fee of 1.5 to two per cent, with a profit interest of 20%. Thus, they share far more in the upside than downside with their outside investors. This gives them a powerful incentive to "go for broke" whenever their fund is doing badly. The dispute cannot be resolved theoretically. Given the conflicts of interest inherent in the corporate form of organisation, it is an empirical question whether private ownership is more efficient than public ownership".* (Martin Wolf Financial Times February 28, 2007)

Reference (b)

An Assessment of Whether Private Equity Could Become a Matter of Concern to the Australian Economy If Ownership, Debt/Equity and Risk Profiles of Australian Business Are Significantly Altered

21. Economic issues are inextricably linked to social issues. The AMWU has serious concerns at the implications of private equity ownership which results in high debt ratios leaving a company and its

employees exposed to short term shocks such as increased interest rates or temporary market downturns. Private equity arrangements are sometimes said to have a number of benefits in terms of:

- Knowledge and expertise
- Speed of decision-making, operational efficiency
- Focus (on cash flow)
- Alignments of interests - incentive/and remuneration

22. However, such benefits, to the extent that they represent genuine benefits in any given investment, can be insufficient to overcome short term shocks associated with the private equity investment and potentially leave a company in financial difficulties or in a worst-case scenario insolvent. A more highly geared and substantially less regulated business sector may not be in the interests of the Australian economy or the employees of individual private equity companies.

23. Most recently these concerns have manifested in the widespread community concern over the private equity take over of Qantas Ltd.

24. International experience suggests that the increased debt profile associated with private equity arrangements means that private equity managers focus extensively on:

    - Buying assets cheaply;
    - Increasing leverage of the companies they acquire from around 25% to 30% (from listed companies) to around 65% (for private equity in this the companies); and
    - Achieving operational improvements by growing revenues or reducing costs.

25. It is the AMWU's view that access to cheap assets will decline and a focus on achieving "operational improvements" and reducing costs

may have unacceptable implications for employees of private equity companies. This focus will have implications for the Australian economy, particularly if the experience in the UK is replicated in Australia. According to David Teathor and Jill Treanor:

- Private equity has become so powerful a handful of films or businesses that employ one in every five workers in the private sector in Britain.
- The firms are largely secretive, rarely give interviews and do not disclose who invest in their funds. The industry meanwhile has made a small number of people who manage the funds immensely rich.
- Within months of buying the AA for 1.75 billion pounds, the private equity owners Permira and CVC capital had cut 3400 jobs.
- Permira the largest private equity group in Europe, last year bought Birds Eye from Unilever and pledged to keep workers employment terms for at least three years. Within five months it had closed plant at Hull at a cost of 600 jobs.
- Workers at NCP, the UK's biggest car parking group, picketed the offices of private equity company 3i this week complaining of a pressure cooker environment and failure to recognize the union.
- The amount spent buying public companies in Britain last year reached a record 26.3 billion pounds.
- Economists fear that in time an economy of higher interest rates could spell disaster.
- Companies that private equity firms have loaded with debts and liabilities like rent are much more vulnerable. (Guardian Unlimited February 23, 2007)

26. The Guardian Unlimited in a Leader column quoted Michael Gordon, chief executive of Fidelity Investment, as admitting that *"employees*

are a little further down the pecking order in private equity". The leader also quotes Steven Ratner, co founder of Quadrant as vigorously defending private equity as *"a constructive force in making capitalism work"* but also admitting that at the moment there was a *"credit fuelled bubble driving private equity deals that would not happen in a normal credit market"* (Taming the New Capitalism, the Guardian, February 24, 2007).

27. It is the AMWU's view that private equity will become a matter of concern to the Australian economy if the targeting of "blue chip" public companies increases and the growth of private equity take overs reach the levels in the UK.

28. Such a course would have serious economic and social implications for the economy and workers and their communities affected by private equity takeovers.

Reference (c)

An Assessment of Long-Term Government Revenue Effects, Arising from Consequences to Income Tax and Capital Gains Tax, or from Any Other Effects

29. As previously discussed the revenue effects to government arising from an increase in private equity take overs should be of concern to government. In the AMWU's view the taxation issues that need to be addressed include:

    (a) The removal of distortions in the taxation system and regulations and the operation of the legal system that creates incentives for mistaken decisions on leverage and ownership.

(b) Whether the growth of private equity requires a general review of tax relief on interest payments.

(c) The taxation treatment of the "2 and 20 structure", particularly the treatment of "carried interest" as capital and not income.

(d) Whether the 2002 venture capital tax concession is providing an unfair or undesirable advantage to private equity consortiums.

30. A recent article in the Guardian by Nils Pratley outlines the taxation issues arising in the UK associated with private equity. Pratley observed that:

> "The elephant in the room has once again been ignored, not just by unions but now by the Treasury. The elephant is the tax relief enjoyed by the general partners in private equity firms"
>
> *It works this way. The partners are the managers of a private equity fund and they earn their rewards two ways.*
>
> *First, by charging an annual management fee, usually between 1.25% and 2% of the funds under management.*
>
> *Second, by keeping 20% of the profit on investment for themselves as a performance fee once investors have cleared a stated threshold.*
>
> *This is the so-called "two and 20" structure and it is the tax treatment of the "20" -- the carried interest in the industry jargon -- that ought to be contentious. Partners are able to claim tax relief on carried interest by treating the sums as capital rather than income. As income, the effective tax rate would be about 40%. As capital, once the relief has been applied, the tax rate can often fall to 10% sometimes lower.*
>
> *This is possible because the partners have been allowed to treat themselves for tax purposes as owners of the companies in which their funds invest. In this way, they qualify for tapered tax reliefs which were introduced by Gordon Brown to give a helping hand to entrepreneurs and start-up companies.*

The sums at stake in this area are far from trivial. Breakingviews.com the financial website, crunched the numbers on a 10 billion pound private equity fund making investment returns of 20% a year for six years, a performance which would be good but not impossible. It calculated that the performance fees for the general partners would amount to 2.8 billion pounds before tax. If the sum was treated as income, the Treasury would collect 1.1 billion pounds. As capital, the Treasury's take would be 210 million pounds assuming a tax rate of 7.5%". (A classical political copout -- Nils Pratley Guardian March 9, 2007*).*

31. The AMWU has serious concerns about any potential loss to the income-tax base through a similar approach applying in Australia. The Australian Taxation Office and Treasury must ensure that the 2002 venture capital tax concession and other taxation instruments are not used to artificially deliver massive windfalls for individuals at the expense of the government's revenue base.

Reference (d)

An Assessment of Whether Appropriate Regulation or Laws Already Apply to Private Equity Acquisitions When the National Economic or Strategic Interest Is at Stake and, If Not, What Those Should Be

32. The AMWU believes that the emergence of private equity take overs requires an assessment of whether the regulations or laws are appropriate.

33. As stated earlier in the submission it is the AMWU's view that tax regulation - including tax deductibility of debt service, tax on capital gains and tax havens needs to be reconfigured to cover private equity regimes so that tax systems remain investment neutral and are not biased towards short-term investment behaviour. Some countries have already either proposed tax legislation to cover the

negative tax effects of the activities of private equity funds (e.g. Denmark) or announced that it would further investigate the effect on their tax systems of such activities. Comprehensive answers should be developed so that increasing activities of private equity funds does not jeopardise government revenues from corporate taxes.

34. The government should examine the legislation applying in Denmark to assess whether there are lessons to be learnt from the Danish response to private equity.

Reference (e)

An Assessment of the Appropriate Regulatory or Legislative Response Required to This Market Phenomenon, If Any.

35. The growth of private equity investment requires a coordinated regulatory response by the international community and the Australian government. The AMWU submits that regulatory reforms should address the following areas:

(a) Transparency, prudential rules and risk management: there needs to be a level playing field between alternative funds and other collective investment schemes with regard to transparency and reporting on performance, risk management and fee structure. Importantly the investment policies of private equity within Australia should be regulated according to prudential rules aimed at both financial market stability and long-term asset value creation.

(b) Workers rights to collective bargaining, information, consultation and representation within the firm should be regarded as key mechanisms by which the long-term interests of companies can be secured and promoted.

(c) Tax regulation: including tax deductibility of debt service, tax on capital gains and tax havens needs to be reconfigured to cover private equity regimes so that tax systems remain investment neutral and are not biased towards short-term investment behaviour. Some countries have already either proposed tax legislation to cover the negative tax effects of the activities of private equity funds (e.g. Denmark) or announced that it would further investigate the effect on their tax systems of such activities. Comprehensive answers should be developed so that increasing activities of private equity funds does not jeopardise government revenues from corporate taxes.

(d) Corporate governance: Current national corporate governance frameworks focus on publicly traded companies and generally have far more and weaker requirements for unlisted companies. In addition, they do not have sufficient mechanisms to guard against short term value extraction and to promote long-term value creation. They are not sustainable to address the challenges of private equity short-term ownership regime. The responsibility and power of the boards of directors to preserve the long-term interests of companies under private equity regime needs to be reinforced.

36. In addition, the AMWU supports the International Trade Union Confederation call for the creation of an international regulatory task force on private equity including the OECD, the IMF, the Financial Stability Forum, relevant UN agencies and the International Labour Organisation.