IUF – Asia and Pacific

international union of food, agriculture, hotel, restaurant, catering, tobacco and allied workers' associations

国際食品関連産業労働組合連合会

serikat buruh internasional sektor makanan, pertanian, hotel, restoran, jasa boga, tembakau dan asosiasi-asosiasi buruh sejenisnya

आंतरराष्ट्रीय खाद्य, खेती, होटेल, रेरत्रां, भोजन पान सेवाएं, तबांकु तथा अन्य कामगार संगठन

國際食品、農業、酒店、餐館、飲食服務、煙草暨同業工人聯會

انٹرنیشنل یونین آف فوڈ، ایگریکلچر، ہوٹل، ریسٹورانٹ، کیٹرنگ، ٹوبیکو اینڈ الائیڈ ورکرز ایسوسی ایشن

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4 May 2007

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
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Canberra ACT 2600
AUSTRALIA

Dear Committee Secretary,

Inquiry into Private Equity Investment and its Effects on Capital Markets and the Australian Economy

We write to make a submission to the Senate Economics Committee on the above mentioned inquiry. The International Union of Foodworkers (IUF) is a global trade union federation representing more than 12 million workers in over 365 organisations in 122 countries, including Australia. The IUF's international headquarters is in Geneva, Switzerland and it holds consultative status at the International Labour Organisation (ILO). The IUF regional secretariat for Asia and Pacific is located in Sydney, Australia.

We are very pleased that the Australian Senate has chosen to investigate the matter of private equity investment. The IUF's affiliated National Union of Workers (NUW) and the Australian Manufacturing Workers' Union (AMWU), with combined membership of 230,000, are very concerned with this issue. The NUW supports the IUF in making a submission to this Inquiry, and the AMWU has made its own submission to the Inquiry. It should be noted from the outset that our submission on private equity investment concentrates on the impact of the leveraged buyout (LBO) form of private equity, and not venture capital, which now forms a very small part of the private equity market.

According to the Reserve Bank of Australia (RBA), up to 2005, the value of private equity deals made in Australia was around AU$2 billion on average per year. However, in 2006, the value of reported private equity deals rose to AU$26 billion. Furthermore, according to the RBA, *all* the growth in 2006 was the result of leveraged buy-outs (LBOs). Before 2006, LBOs accounted for roughly 5% of all mergers and acquisitions of Australian companies. [1] In 2006, in terms of value, they accounted for 25% of those transactions. It is these LBOs by private equity and the risks that they pose with which the Senate Economics Committee and the Australian government should be primarily concerned.

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[1] Reserve Bank of Australia (RBA) "Private Equity in Australia" **Financial Stability Review** March 2007.

At present, there is a great deal of discussion in Australia and overseas about the impact of private equity, however much of that discussion has been very narrowly focused around the risks of increased debt-equity ratios, and the possible consequences of future interest rate rises and the flow-on effects of any international downturn for institutional investors such as Australian superannuation funds. These are all valid concerns which the IUF and its affiliates share.

However, the debate in Australia has been limited, as much of it has been dominated by groups with vested interests in the promotion of private equity. Such groups claim that private equity 'creates jobs' and 'boosts economic efficiency'[2].

These claims need to be examined carefully. In the first place, private equity funds and their supporters cannot claim, as some have, to have created jobs where in actual fact all they have done is continued to 'provide' already-existing jobs in an acquired company. Nor can private equity be credited with job creation in companies which were already enjoying growth prior to a LBO. Furthermore, when new jobs *are* in fact 'created' following an LBO by private equity, it is almost always the case that these are outsourced or casual jobs that have replaced secure, permanent employment in the name of cost-cutting.

The claim that LBOs lead to greater economic efficiency is also extremely contentious. Private equity investors finance acquisitions through debt – often up to 80% of funds for a buyout are borrowed. The target company is then shouldered with the debt burden at worryingly high levels of interest in many cases, as well as the myriad of financial fees levied by the buyout fund. Following the initial leveraged buyout, private equity companies then impose further debts on the acquired company in order to deliver massive dividends to investors. These dividend recapitalisations or 'dividend recaps', as they are known, are in turn funded by further waves of asset stripping and job losses. Essentially the discretionary expenditure of the acquired company is severely reduced as a consequence of increased debt obligations.

In many cases private equity targets companies which are not in trouble, but are in fact recording significant profits and a healthy share-price. The most high-profile case at present is the proposed Qantas buyout. Qantas has recorded growth in profits for 14 consecutive years. This company, in which some IUF affiliated unions have membership, is not in financial difficulty. The private equity consortium making the bid, Airline Partners Australia (APA), has announced plans to take A$4 billion out of the company in the first 12 months of the planned buyout. According to a report in *The Australian*, APA "plans to 'encourage' Qantas to conduct a capital management review that would see the airline incur significantly more debt."[3]

This is worryingly familiar to anybody who has followed the destructive path of private equity across Europe and the US. For example, in Germany the chemical company Cognis was acquired for €2.5 billion in 2001 in a buy-out led by private equity firms Permira and Goldman Sachs. In the year prior to the buy-out, Cognis had an after-tax profit of €109 million. Following its takeover by Permira and a round of dividend recaps, Cognis was so

[2] For example, see Price Waterhouse Coopers, **Economic Impact of Private Equity and Venture Capital in Australia** 2006.

[3] "APA to rip $4 bn out of Qantas", **The Australian**, 13 April 2007.

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.

This could happen to Qantas. Through the capital management review that APA plans, Qantas will effectively be forced to pay for its own sale, through debt.

In Australia, although private equity has yet to take hold in the same way it has in the US and parts of Europe, there are already examples of the threats posed by private equity buyouts. One of the most disturbing aspects of the rise of private equity is the fact that no company is safe, no matter how big or how profitable, from a takeover bid. Even the threat of a takeover can have serious consequences for the employees of a company – as demonstrated by the case of Coles Myer in 2006. In early 2006, the company divested itself of the Myer retail chain and its associated freehold titles, to private equity firms Newbridge and Texas Pacific Group. Then late last year a consortium of private equity firms led by Kohlberg Kravis Roberts (KKR) made a takeover bid for what was left of Coles. This initial takeover bid was repelled, but only at the cost of 2,500 jobs, which the management saw fit to eliminate in order to 'deliver value' to shareholders as the private equity funds would have done if the acquisition had taken place. The 2006 job-cuts were announced on the same day that Coles-Myer reported an 82% jump in profits.[4]

Internationally, in the UK, Europe and the US, where private equity has been active for longer and on a far greater scale, the impact of these trends is clear. Due to the sheer magnitude of the funds available to private equity, the largest multinational companies are now very real targets for buyouts, and as a consequence have been forced to implement the same cost-cutting and restructuring measures in order to deliver massive returns to shareholders. In the case of private equity buyouts, these massive returns are financed through additional debt taken on by the acquired company.

In 2003 Debenhams, a major UK department store chain, was taken private by CVC, Texas Pacific Group and Merrill Lynch Private Equity using £1.4 billion in debt and just £600 million in equity. The buyout was financed by mortgaging the real estate on which Debenhams stores are situated, as well as loans made against the company's assets. Through dividend recaps, company debt was increased from £100 million to £1.9 billion to finance dividend payouts of £1.3 billion to the 3 private equity firms. They 'exited' the investment by floating Debenhams shares on the stock market – just 30 months after taking it private. With the £1.3 billion in dividends alone the private equity firms doubled their money in just 30 months, leaving Debenham's seriously indebted. [5]

Another example is that of Eircom, Ireland's national telecom provider, a company in need of long term strategic investment. The company was privatized by the Irish government in 1998 and acquired by the private equity consortium Valentia in 2001. Eircom paid for the loans by issuing bonds which raised its debt from 25% to 70% of its assets. When the company was taken private in 2001 it was carrying net debt of €340m, and when it was sold

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[4] "Coles Myer to cut 2500 jobs", *The Age,* 21 September 2006

[5] "Private equity group puts £3bn price tag on Debenhams as it floats for third time" *The Guardian*, 21 April 2006 and John Russell "Private equity – Humbling the barbarians" 1 April 2007

back to the public in March 2004 debt was €2.3 billion. Eircom capital expenditures declined from €700 million in 2001 to €300 million in 2002 and €200 million in 2003 and 2004. *While cutting back radically on investment Eircom paid a €400 million dividend to Valentia.* The private equity group is estimated to have made a return of between 60% and 80% over the three years of its investment; between 2004 and 2005 it was estimated that Eircom was to cut its workforce by 12%.[6]

As these examples clearly demonstrate, the key factor about private equity and the leveraged buyout is the drive to extract maximum returns in the shortest-possible timeframe. With the rise of private equity, all financial players are under increasing pressure to deliver unsustainably high returns on investment. Private equity firms generally set a target of 25% rate of return per annum, but in the case of some larger funds returns of up to 40% can be generated. Furthermore, as many observers have noted, private equity firms typically look for a three- to- five-year exit.

In this context of short-term, impatient investment, it is not only jobs that are sacrificed to satisfy private equity's demand for massive returns and a constant stream of ready cash. There is no space for consideration of any kind of long-term strategic investment - including in areas such as research and development. The case of the Findus Group in Europe exemplifies this problem. Findus, formerly the frozen foods division of Nestlé, was acquired by EQT, a 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. Today there are 6 plants - only one left in Sweden. Research staff at the company's Swedish headquarters has been reduced from 200 to 40, despite a substantial need for investment in research and innovation due to a diminishing market for frozen foods. In 2006, Findus was 'flipped' – that is, sold to another private equity firm, CapVest, in an operation which will undoubtedly pile on new debt.

Such examples of the detrimental impact of private equity buyouts on strategic investment in research and development have important lessons for Australia, where there is already concern amongst many in the business and academic communities about the 'brain drain' and the declining rate of investment in research and development and skills development. There are well-founded concerns about the consequences of these problems for productivity in the future – problems will only worsen as private equity takes a greater hold in Australia.

The IUF strongly urges the Senate Economics Committee to consider these matters more closely. The Reserve Bank of Australia (RBA) has identified a number of other trends which merit serious concern:

- further increases in leveraged debt in the coming years;
- significantly higher rates of interest associated with LBO debt;
- higher levels of risk economy-wide as competition forces companies to beat the already extremely risky rates of return on LBO investments;
- decline in transparency (e.g. disclosure provisions and financial reporting are significantly reduced when previously public companies are delisted);

[6] See "Eircom in Ireland" pp10-11 in William H. Melody **The Private Equity Takeover of Telecom Infrastructure in Denmark: Implications for Network Development and Public Policy** April 2007; and **"Parting Company"** CFOEurope.com, December 2004.

- the possibility that "large losses by a few highly leveraged firms have the potential to affect the wider economy." [7]

At the same time, the RBA has essentially recommended a wait-and-see approach on the question of regulation, leaving the financial and corporate world to self-regulate and arguing that sufficient legislative tools exist.

We believe this position to be wrong.

On 8 March, the UK Economic Secretary to the Treasury, Ed Balls MP, announced a review into private equity activity, specifically focused on whether the UK tax system gives an unfair advantage to private equity over other forms of ownership.[8] This inquiry has come about primarily because LBOs result in firms being able to greatly increase tax deductions due to their much greater levels of debt. Such a situation also raises potential conflicts of interest, since firms involved in LBOs are often financial institutions that have an interest in driving debt levels as high as possible, since returns on debt would be higher than the profits the acquired firm might make from normal business.

The complex multiple-party financing of much LBO activity breeds systemic risks as well as decreasing transparency in economic transactions. An April 2007 European Central Bank (ECB) report[9] highlighted these concerns in its conclusions:

- *…credit risk exposure linked with LBO deals remaining in the banks' balance sheets is mechanically more sensitive to deterioration in the economic cycle than traditional credit risk, due to the leveraged nature of LBO deals;*

- *Due to the large amount of funds funnelled to the LBO market over the past few years, the potential for excessive asset inflation and risk mispricing is evidently stronger.*

- *The growing interrelationships between financial markets (debt, equity, derivatives, etc) create new channels of contagion through which liquidity problems may propagate.*

- *…it cannot be excluded that the current market assessment of the strength and resilience of the LBO market is somewhat biased as the availability of equity cures and existing incentives for investors to avoid complex workouts may temporarily help in hiding or postponing existing problems.*

This situation produces particular concerns in the Australian context, where superannuation funds (whose assets are derived from the compulsory savings of millions of workers in Australia) are increasingly entering the into private equity investments. The potential for a financial meltdown to severely impact the value of those savings is clear.

The emergence of private equity LBOs signals a dramatic change in the nature of economies worldwide, in which all aspects of a firm's activities become subordinated to the pressure to

[7] Reserve Bank of Australia, op.cit. 2007

[8] Speech by the Economic Secretary to the Treasury, Ed Balls MP, London Business School, 8 March 2007.

[9] European Central Bank (ECB), **Large Banks and Private Equity-Sponsored Leveraged Buyouts in the EU**, April 2007.

meet highly-inflated short-term returns to investors, rather than addressing needs in a socially-productive manner. It is not just the short-termism which is a problem (a problem it should be noted which has long destabilised our economic system), but also the extremely high annual returns on investment of up to 40% which private equity investors are now demanding.

Such an economic model is neither sustainable nor just.

We believe that the unbalanced risk/return situation – in which workers and consumers are placed in positions of undue risk in order that large-scale capital investors can make undue returns - needs to be rectified by regulation. Broadly speaking, there are four specific areas of concern which have been raised in terms of regulation in both Europe and the US, and which need to be considered in the Australian context. These are:

- Risk
- Taxation
- Fees
- Disclosure/transparency

There needs to be an increased regulatory oversight in light of the heightened systemic risk posed by the debt-heavy nature of private equity buyouts. There should be a regulatory program by which superannuation funds and other institutional investors are limited in their scope to put funds into investments where debt-equity ratios are disproportionate.

The issue of taxation and lost revenue to government due to the elimination in 2006 of the 30% capital gains tax for foreign investors is another matter that needs serious consideration. One commentator estimates that this lost revenue will reach $2 billion in 2008.[10] A spokesperson from the Treasury told the same commentator that lost revenue had not been calculated and that 'nothing could be done' about this because the government was not prepared to legislate on corporate debt.[11] Yet these are exactly the kinds of measures needed. Minimising or eliminating capital gains tax is a core element of the leveraged buyout in Australia. It can be no coincidence that the value of private equity takeover bids, many led by prominent international private equity firms, has jumped so alarmingly in the very same year that the 30% capital gains tax was eliminated for foreign investors. This echoes the situation in Germany following a simple revision to the corporate tax code in 2003, which prompted a rush to loot company cash through leveraged buyouts.

These tax subsidies leave other companies and society as a whole to fund the deficit. A core issues here is: the treatment of cash flows within the acquired companies. Current tax law 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. In a related issue, there is a need to prevent private equity fund managers from writing off their various fees as 'costs' rather than income.

Finally the issue of public disclosure and transparency is key. In Australia the 'principles' based approach to corporate governance as described by the RBA in its recent report is

[10] "Sailing through the tax system" **Sydney Morning Herald**, March 23, 2007

[11] Ibid.

simply not sufficient.[12] As one Australian commentator has rightly observed, "public reporting is not simply for shareholders, but for other stakeholders too".[13] Chief among these "other stakeholders" are employees of companies which are bought out by private equity. There is a need to prevent private equity firms from evading their responsibilities as employers, as they do, whilst at the same time attempting to take credit for 'creating jobs'. This is a debate which has developed in the US and Japan, for example – where the Japanese parliament has turned its attention to the matter of private equity firms and their employment responsibilities.[14]

The IUF has made many of these points in more detail in previous research into the issue of private equity and what is called the 'financialization' of capital. We attach here for the interest of the Economics Committee an article entitled "Financialization: New routes to profit, new challenges for trade unions"[15] written by officers of the IUF.

We appreciate your consideration of our submission,

Yours sincerely

Ma Wei Pin
Regional Secretary

[12] Reserve Bank of Australia, op.cit., 2007.

[13] "Probes aplenty, but don't expect action", **Sydney Morning Herald**, 14 March 2007

[14] Interview with Kunio Akiyama, Vice President, Service Tourism Rengo, IUF Asia & Pacific

[15] Source: **Labour Education**, Journal of the Bureau of Workers' Activities (ACTRAV), ILO, 2006.