International Union of Food, Agricultural, Hotel, Restaurant, Catering, Tobacco and Allied Workers' Associations

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Private Equity Buyouts: A Trade Union View

Public Hearing on Hedge Funds and Private Equity - Committee on Economic and Monetary Affairs of the European Parliament

Good afternoon, My name is Peter Rossman, I am communications director with the IUF, an international federation of trade unions in the food, agriculture, plantation, hotel, restaurant, catering and tobacco sectors. We are made up of 373 member trade unions in 122 countries representing some 12 million workers. We're very pleased to be here, and I want to thank the ECON Committee and Poul Nyrup Rasmussen in particular for this very important initiative.

The IUF is a global organization with a long history. Unlike many of those who've been celebrating the leveraged buyout boom of recent years we recall that what we've just been through is in fact buyout boom, or buyout bubble, number 2. The first took place in the second half of the 1980's and was largely confined to North America. When it crashed at the end of the decade, it left behind more than just a few jailed junk bond traders. The LBO's of the 1980s destroyed a number of American manufacturing companies and were an important contribution to the hollowing out of US manufacturing capacity, one result of which is the US balance of payments deficit which has become a major source of global financial instability. The most famous LBO of the period, the 38 billion-dollar buyout of RJR Nabisco by KKR, resulted in the loss of 40,000 union jobs in the US alone, and billions in lost tax revenues to government through the absurd tax subsidies which reward the massive use of corporate debt.

The RJR Nabisco buyout epitomized the trends of the period, trends which we saw magnified in the second wave: bigger and bigger deals, growing use of leverage, although not as high as the debt multiples of over 10 times free cash flow which characterized the bigger recent deals; and the transformation of real companies with real assets and real employees into a bundle of financial assets to be sold off for cash returns to investors in the shortest possible time. Nabisco today exists only as a collection of scattered brands managed by various food companies as simply another financial product in their portfolios. Its fate in this respect is not unique.

At the beginning of the Clinton administration there was talk about addressing the fundamentals of the buyout disaster through new regulation, but attention was quickly absorbed by the savings and loan crisis and private equity was forgotten. That holds a lesson for today, because the fallout from the subprime collapse risks diverting attention from the very real dangers which LBO debt holds for global financial stability.

Instead of regulation, there followed two decades of global financial **de**regulation and a loosening of tax regimes. When conditions became ripe again, we had buyout boom number 2, this time on a global scale.

The total volume of buyout deals for 2006 has been estimated as high as 725 billion USD. 2007 was set to surpass that, until the credit crunch froze the big deals. Financial deregulation made it possible for the banks which funded the buyouts to offload their risk through a whole new breed of credit instruments which were largely unregulated. We were presented with wonderful innovations like "covenant lite", "toggle loans", PIK notes and so on – all basically instruments for funding debt through more debt. Debt was piled onto the books of the portfolio companies, and debt was diffused through the financial universe, in fact so widely diffused that probably no one in this room can provide a plausible estimate of the outstanding volume of LBO debt, the forms in which it exists, or who owns it. In this respect it is no different than the loans which were packaged and repackaged on the basis of subprime mortgages. The total volume is somewhere in the trillions.

The essential point is that a major default in the LBO debt market, with its inevitable chain reaction, could just as easily have triggered the current crisis as the subprime mortgage derivatives. And it may yet happen, seriously amplifying the current crisis. As Michael Gordon of Fidelity International wrote in a March 31 Financial Times editorial, "Private equity as we have come to know it is all about debt - lock, stock and sinking barrel."

Piling large amounts of debt onto the books of a company taken private, with the goal of high short-term returns, means there is nothing left for investment in the future. Here are some examples:

In 2005 the Danish telecommunications operator TDC was taken over by a group of five of the biggest private equity firms - Permira, Apax, Blackstone Group, KKR and Providence Equity for €12 billion. Over 80% of the purchase price was debt financed. As a result the company's debt to asset ratio jumped from 18% to over 90%.The equivalent of over half the company's assets were then immediately distributed in shares to the new owners and top managers.

TDC is no longer a leader in wireless technology.

The Irish telecommuications company Eirecom was acquired by the private equity consortium Valentia in 2001. Eircom paid for the loans through bonds which raised its debt from 25% to 70% of its assets. 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 the company paid a €400 million dividend to Valentia.

In the food sector, Findus, Nestlé's frozen foods division, was acquired by the Swedish private equity fund EQT, in 2000. At the time of the purchase Findus had 14 plants in Europe with 3,400 employees. Today there are 6 plants - with 2,900 workers. Research staff at the company's Swedish headquarters was cut from 200 to 40. In 2006, what was left of the company was sold to another financial investor. The union representative who sat on the management board says "I lost track of how many loan agreements we signed. EQT had to keep changing banks when they didn’t fulfil the loan requirements. And the company was constantly in the credit rating magazine Justitia for not paying its bills. We couldn’t even buy petrol with the company’s credit cards.”

The private equity firms who did these deals are not "rogue traders" – they are among the biggest and best known buyout funds, and they continue to raise record sums for investment. This is standard operating procedure for what has been highly praised as a successful model for "unlocking value" and efficiently aligning the interests of owners and managers.

Eirecom today is what is known as a private equity "zombie" - the company is worth less than what it owes, and is technically bankrupt. It is not alone. In the UK last year, the number of private equity-owned companies falling into receivership rose by 50%. More than a quarter of the 400 companies disposed of by private equity in 2007 went bankrupt.

Private equity buyouts have been described as a tool for "enhancing efficiency in financial markets." For workers, the private equity bubbles have been a social disaster. The recent study by the World Economic Forum on the destructive job impact of private equity buyouts simply confirms what unions have been saying for many years from direct experience - both the quantity and quality of jobs suffers under private equity ownership.

The private equity boom has fed the general tendency for companies to return more and more to investors in the name of shareholder value. We have seen an exponential increase in the share of cash flow devoted to dividends and share buybacks at the expense of long term, productive investment. Nestlé, the world's largest food corporation, last year spent 26 billion CHF on buying its own shares – a year which began with its chief financial officer warning that the company's capital stock was "dangerously weak". For workers, the declining rate of real investment has meant that productivity is boosted in the short-term by extracting more with less; reducing payroll and increased reliance on outsourcing and casualization, which creates long chains of precarious labour. All of this results in a general degradation of working conditions, and it is not sustainable for workers or for companies.

Finance is supposed to be assisting the real economy of goods and services. The quantity of global credit derivatives in circulation now exceeds world GDP by a factor of 8. The value of credit default swaps is over 8 times greater than the corporate bonds they are supposed to be protecting. Staggering amounts of money is pouring into financial markets, yet we see a relative decline in real investment, and in some OECD countries the share of wages in the national income is at its lowest level since the Great Depression. Venture capital - seed money for startups - is a small and declining percentage of the money allotted by private equity funds. The largest European private equity fund specializing in venture capital - 3i - last month announced that it was getting out of venture capital because it was not profitable enough. They will be increasing their allotment to buyouts. Something is clearly very wrong.

Let me close with an example which brings into relief the issues I've raised.

In 2001 the private equity firm Permira, put €450 million into a deal to buy the German chemical company Cognis for €2.5 billion. In the year prior to this takeover, Cognis had an after-tax profit of €109 million. Following its takeover by Permira and a dividend recapitalization, Cognis was so burdened with accumulated interest payments that despite rising sales it registered a loss of €136 million in 2006**.** Yet Permira and Goldman Sachs have already taken €850 million out of the company. The debt was refinanced in May 2007 by issuing new loans and notes worth some €1.65 billion. Cognis has been hit by rising raw material prices and may not survive.

Look at how this works. A financial company advises Cognis on its own takeover and pockets millions in fees. That same financial corporation, together with a private equity fund, takes the company private and funds the operation with debt, getting their money back quickly through dividends, and then piles more debt on the company. All of these actions violate elementary standards of diligence, and in fact should be illegal. The consequence is an uncertain future for the company and its workers and a flood of dubious paper rated double and triple A by the rating agencies even though no one has a more precise idea of its actual market value than they do for a collateralized debt obligation derived from a subprime mortgage.

Workers want secure, long-term investment that can bring about decent jobs through work which is socially and environmentally sustainable. We want investment in education, training and research, and we want to know that quality retirement and health systems are available for all to enjoy. Those are goals which are presumably shared across the democratic political spectrum. What we see today is a regulatory and tax regime which takes us in the opposite direction, and a threat of global financial meltdown. That is why we strongly support proposals for a thorough regulatory review and appropriate action to rein in the destructive impact of private equity buyouts. Surely another form of finance is possible.