



## **Memorandum of Evidence to Treasury Select Committee Inquiry into Private Equity**

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Amicus is the UK's second largest trade union with 1.2 million members across the private and public sectors. Our members work in a range of industries including manufacturing, financial services, print, media, construction and not for profit sectors, local government, education and the health service. The union has recently merged with the TGWU to form the UK's largest union of over 2 million members.

### **1. Executive Summary**

#### **1.1. Accountability**

1.1.1. It is clear to Amicus that a transparent approach to all management buy-outs, leverage, mergers and acquisitions is required. Amicus welcomes the suggestion for a code of conduct for the industry but would also want to see some form of explicit regulatory body for private equity companies

1.1.2. Amicus would welcome a European Union regulation on transparency and regulatory compulsion for private equity companies. Amicus believes it is worth considering this to give workers across Europe the same regulations to protect their rights, regardless of which country their employer is based in.

#### **1.2. Taxation**

1.2.1. Amicus believes there needs to be a clear distinction between the taxation of companies and the taxation of personal income. At present managers of private equity companies are able to offset their personal tax liability by retaining the profit for two years and declaring it as capital gains, reducing their tax liability by up to 30%.

1.2.2. A review of the British tax structure is required to ensure private equity companies do not enjoy a level of comparative advantage that may distort financial markets. Whilst accepting that investment in British companies is to be welcomed, this should not be at the expense of UK workers.

### **1.3. Employment Relations**

- 1.3.1. The short term strategies employed by private equity companies are a threat to sustainable company growth and investment in the form of research, development and innovation. The drive for short term, extensive financial returns creates a situation which leads to downward pressure on wages and working conditions.
- 1.3.2 Amicus believes the Information and Consultation regulations should be strengthened to ensure that companies targeted by private equity groups are compelled to discuss this with the workers and the union involved and to outline any future strategic restructuring that may result in the loss of jobs or company closures.
- 1.3.3 Amicus is sceptical that private equity companies create jobs in the long term. While some research and information gleaned from private equity companies creates this image, there is substantial evidence from trade unions that many thousands of jobs have been lost due to the rapacious restructuring of companies bought out by private equity groups. Amicus would like to see an exploration of the possibility to extend the present Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) to include transfers made through share purchases.
- 1.3.4 Amicus believes there are significant issues around company pension schemes in relation to private equity companies. The foremost of these is that trustees of any existing pension scheme may be concerned that the new private equity owners will be less able to fund the existing pension scheme because of high levels of leverage. Amicus would suggest that substantial up front assets are required to ensure protection of any scheme.

### **1.4. Financial Stability**

- 1.4.1. Both the European Central Bank (ECB) and the International Monetary Fund (IMF) have expressed disquiet over the rise in private equity activity and especially the level of leverage incurred. Amicus believes the management of systematic risk can be achieved through the introduction of improved requirements for national regulations to improve reporting procedures and the creation of an EU framework to rate private equity companies according to investment strategy and risk.
- 1.4.2. A number of European countries have taken action to slow the proliferation of private equity purchases. Denmark has closed a loop-hole in its tax structure which enabled companies to off-set tax, but has reduced the amount of Capital Gains tax that companies need to pay. They feel this will stop some of the worst examples of voracious company buy-outs but will still encourage

investment in Danish economy. The German Government has expressed its concern and is also looking at ways to address private equity proliferation without compromising Foreign Direct Investment. This may feature on the G8 agenda. The US Congress has started Hearings into the workings of the private equity industry.

## 2. Introduction

2.1 The recent blaze of publicity around private equity companies has shown that what was once a small player in the financial services sector has burgeoned into a spectacular growth industry. The specific circumstances that have allowed this growth are crystallised in what is happening in the wider financial market in the UK today.

2.2 The strong recent development of the industry in the UK has been facilitated by benign economic conditions and a vast increase in funds available. There are also more institutional, charitable and professional investors being attracted to the industry, mainly because of the huge financial returns that are possible.

2.3 The industry predominates in the US and the UK however there has been significant growth in the industry in Europe. In 2006 the value was €178 billion, a 40% increase on 2005. Eighty per cent of which went to buy-outs, two thirds of which were for deals of over €1 billion<sup>1</sup>

2.4 At this present time, British firms controlled by private equity companies generate total sales of £424bn, export goods and services to the value of £48bn and, according to the British Venture Capital Association (BVCA) account for 2.8 million private sector jobs, equal to 19% of private sector employees<sup>2</sup>.

2.5 Amicus believes that the private equity model cannot be discussed without looking at the wider changes that have happened over the past decade to the way companies fund their businesses, the way financial markets operate and what impact this has on workers and the UK economy generally.

2.6 Amicus acknowledges that the companies involved in the private equity business rely on the undertaking of substantial financial risk, with huge amounts of leverage funding the purchase of other companies. However, this level of leverage can be incredibly lucrative to the managers and private equity companies themselves, but can also be devastating to the workers in the companies, to the companies themselves and to a certain extent the wider supply chain.

2.7 This process of profiteering is causing some consternation in the wider economic and social arena. The Financial Services Association (FSA), trade unions, workers within the companies and political commentators are questioning the accountability, transparency and honesty of the way the private equity companies go about their business and what wider impact this has industrially, socially and economically.

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<sup>1</sup> PriceWaterhouseCoopers, European Private Equity, Geneva - 13 March 2007.

<sup>2</sup> The Observer, Business and Media section, Sunday 11 February 2007.

2.8 For example, Nestlé – the world’s largest food company substantially funded by private equity announced a 21% increase in net profits and a 12.5% dividend in 2006. They also announced they were allocating 1 billion Swiss francs for a new round of share buy-backs; this is in addition to the 3 billion franc share buy-back implemented 3 months earlier. This is without doubt one of the reasons why Nestlé chose not to invest in its Rowntree factory in York. As a consequence of the lack of investment, 1000 Amicus members were made redundant and production of a number of quintessentially English confectionary products such as Kit Kat and Smarties were moved abroad.

2.9 Amicus believes that the main purpose of any investigation into private equity groups must also encompass the wider economic dimension. This should include addressing questions such as why there is such a preferential tax regime for leverage, why do company managers and private equity directors enjoy profits that are classed as capital gains and not earned income and why workers in these companies frequently do not share in the benefits financially or industrially derived from the huge profits being made.

2.10 The wider dimension also includes questions around accountability, corporate governance, employment relations and financial stability. On the one side are the inflated salaries, bonuses, stock options and dividends that managers enjoy, while on the other side is the alarming decline in real investment as a percentage of company cash flow once all the above have been paid out.

2.11 The reduction of income retained within the company can mean that research and development stagnates, productivity declines once the impact of job cuts and ‘hard HR’ practices bed down and staff training and development falls by the wayside completely. Amicus believes that private equity companies do not make ‘good’ employers and the workers within the companies do not enjoy a ‘good work’<sup>3</sup> ethos.

### **3. Accountability**

3.1. One of the major problems with the private equity sector has been its rigid adherence to secrecy and privacy. There is very little published information about private equity companies similar to that of companies listed on the Stock Exchange. Listed companies have an obligation to provide financial reports and annual returns that will include remuneration to individual directors and executives, the number of employees and the overall salary bill. Private equity companies are not obliged to provide any of this. It is therefore very difficult to track changes to employee numbers, salaries paid and site closures.

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<sup>3</sup> Please see, ‘Good Work’ – an Amicus agenda for better jobs  
<http://www.amicustheunion.org/pdf/Good%20work.pdf>

- 3.2. When listed companies are bought-out by private equity companies the access to information on them is immediately curtailed, they escape any financial regulation, shareholder accountability and the need to supply accounting returns. It is this level of secrecy and lack of transparency that rings alarm bells for trade unions and the Financial Services Association, ultimately prompting a focus on the negative aspects of the industry.
- 3.3. The lack of transparency, scrutiny and regulation is something that Amicus would want to see addressed. It is not acceptable that an alternative form of investment has such power over business and global economies, yet is constructed in a way that the US and UK governments positively encourage through light regulation and tax minimisation. The UK Treasury has suggested a more open approach, but has made it clear that the present governance and regulations will not be changed<sup>4</sup>
- 3.4. Amicus believes that the growth in private equity takeovers is not a natural process of the UK market economy. The rise has happened because of the preferential and benign tax regime, low interest rates and vast amounts of capital that are in place at present in the UK. The present economic climate has provided the impetus for the industry to grow and with the level of profits it can achieve, the industry has grown exponentially. The UK government has also ensured that with its laissez-faire attitude to financial regulation and tax liability at this level, the private equity companies have taken advantage of every opportunity to reap the huge personal financial rewards on offer.
- 3.5. The latest move towards regulation has seen the setting up of a working party headed by Sir David Walker. The working party are tasked with establishing a voluntary code on a comply or explain basis to address the issue of disclosure. On past experience Amicus is not convinced that a voluntary code will work, but will be interested to see the outcome of the working party's findings.
- 3.6. Amicus would like to see a European wide regulation on transparency and regulatory compulsion for private equity companies. Amicus believes it is worth considering this to enable workers across Europe to enjoy the same rights and benefits regardless of which country they work in and, more importantly, regardless of where the company they work for is located.

#### **4. Tax Incentives and Personal Liability**

- 4.1. Amicus believes that there needs to be a distinction between the taxation of companies and the taxation of the income accrued by the managers of private equity companies. Currently companies can earn 30 per cent tax relief on debt interest payments. The nature of the structure of private equity companies means that they are able to

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<sup>4</sup> FT Companies and Markets, Friday 2 March 2007.

borrow very heavily without having to explain to shareholders what they are doing. The existing UK tax regime encourages leverage because of the tax relief on debt and because interest payments can be set against profit, reducing a company's liability for corporation tax.

- 4.2. For publicly listed companies the prospect of borrowing as heavily as private equity companies presents them with serious problems. They have shareholders to respond to and borrowing heavily could compromise their viability and ability to raise money in the capital markets if their balance sheet shows a great deal of debt. Consequently, their credit rating could be downgraded which could have a devastating effect on their long term prosperity. Private equity companies do not have any of these problems to contend with.
- 4.3. For the managers of private equity companies the situation regarding personal tax liability is incredibly benign and advantageous. The key people are remunerated in part by being given share stakes in the companies they acquire. For example, if someone has a 2 per cent stake in a company that has a share out of £500m then that person gets £10m. Under the present regulations this is called 'carried interest' and under legislation introduced by Gordon Brown in 1997, is treated as capital gains, not income, and is therefore eligible for tapered tax relief. As long as the investment is held for two years, the tax liability comes down from 40% to just 10%.
- 4.4. The rules were introduced to encourage people or companies to provide venture capital and to fund companies that may be deemed as relatively risky. However, under the present economic climate the system is being abused and exploited to enable private equity companies to make huge amounts of profit.
- 4.5. Amicus would like to see the Treasury justify its decision to remove the lower rate of income tax – forcing lower paid people, many of whom will work for Private Equity companies, into the benefits system, while creating a tax system that enables managers of private equity companies to pay much lower rates of tax on their personal income and even less on their leverage commitments.

## **5. Employment Relations**

- 5.1. In the event of mergers or acquisitions, companies often resort to restructuring leading to job losses. The important factor is whether the restructuring is then used to expand the company once the benefits are achieved. There is evidence that when private equity companies take over companies, corporations or enterprises, they often treat them simply as bundles of assets and only view them through the term of rates of return that can be achieved in the short term with no interest in longer term strategic development. However, these companies are often employing thousands of workers whose livelihood, family cohesion and community stability is entrenched in their employment with the company.

- 5.2. An example of this is Permira's decision to shut the Birds Eye factory in Hull with the loss of over 600 jobs, five months after purchasing the company from Unilever for £1bn. The staff involved were not kept fully informed and had no protection from the rapacious and relentless decisions made about the companies viability and their job security.
- 5.3. Amicus believes the Information and Consultation regulations should be strengthened to ensure that companies targeted by private equity companies should be compelled to discuss this with the workers and the union involved and to outline any future strategic restructuring that may result in loss of jobs or closures. Amicus believes that private equity owned companies have an obligation and a responsibility to tell their workers who actually owns the company and what long term strategy for the growth and development of the company will be. This can only be achieved with improved government regulation or changes to UK or European Union Law.
- 5.4. There are many examples that show how the loss of jobs in the UK through company takeovers by private equity companies have far reaching social and economic implications for workers and communities. Amicus is seriously concerned that managers of private equity companies do not consider this in any decision making process.
- 5.5. The short-term strategy employed by private equity investment (3-5 years) is obviously a threat to sustainable company growth and investment in the form of research, development and innovation. The constant drive for short term financial returns also creates a situation which leads to downward pressure of wages and working conditions. This means where jobs are not immediately lost they can end up as work of low quality, and low pay. Paul Myners, the former chairman of Marks & Spencer expressed his concern over the issues around job security, working conditions and pay for workers employed by private equity companies, 'the one party that is not rewarded is the employees, who, generally speaking suffer an erosion of job security and benefits'<sup>5</sup>
- 5.6. Amicus believes that there are significant issues around company pension schemes in relation to private equity companies. The foremost of these is that trustees of any existing pension scheme may be concerned that the new owners will be less able to fund the existing pension scheme because of high levels of leverage. An example of this is where the trustees of the Sainsbury's pension scheme expressed concern about the private equity bid for the supermarket. They warned that the scheme's £400m deficit could swell to £3bn and said a private equity takeover financed with multi billion-pound debt

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<sup>5</sup> Financial Times, Risks in the growth of Private Equity, Wednesday 21 February 2007.

“would naturally have implication for the trustees’ approach to security, the funding position and the appetite for risk”<sup>6</sup>.

- 5.7. The UK has a Pensions Regulator that can intervene in company transactions where it feels the security of a pension scheme is compromised. Amicus believes this scrutiny should apply to all forms of change of ownership and where the regulator is required to intervene they should consult with trade unions as well as trustees. Amicus also believes that to protect company pension schemes, any private equity business plan must rank its pension scheme obligations ahead of its bank lenders in the event of any insolvency.
- 5.8. Where private equity companies show a disinclination to look at the long term and in so doing create a break down of existing procedures, structures and working practices, the role of the trade union becomes marginalised. Working in conjunction with employers when the actual owners are nowhere to be seen and who make economic decisions based purely on the acquisition of short term profit leaves workers and their representatives excluded.
- 5.9. Amicus acknowledges that there is a difference between venture capital and private equity. Many of today’s niche, innovative industry’s such as mobile phone technology and Space technology by-products would not have reached the market if the listed companies concerned had taken a short term approach to financial reward – start-up capital is clearly needed, but this is a very different approach to that which private equity companies use in their pursuit of exponential financial rewards.
- 5.10. Amicus believes that the evidence presented by private equity companies and research from Nottingham University about the creation of more jobs by private equity companies does not show the true picture. Evidence from many trade unions working on behalf of workers in private equity owned companies show that job losses are far higher than reported and that levels of intimidation and breaches of Employment Law are endemic.
- 5.11. A good example of corporate bullying is what happened at the AA. The owners de-recognised the union, closed units and offered many staff a take-it-or-leave-it offer of £18,000 to leave, this was then reduced to £12,000 for the second round of redundancies. To this end Amicus believes that there is a significant need for a robust piece of independent research investigating the social, economic and industrial consequences of the private equity model.
- 5.12. Amicus also notes that private equity companies feel no compunction to be accountable to the workers in the companies they are taking over. It is clear from the evidence of company buy-outs that

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<sup>6</sup> The Guardian - Business section. Saturday 24 March 2007.

the last people who are informed about what is happening is the workers. Mergers and acquisitions are pursued on the back of cost cutting and maximising profit<sup>7</sup>.

5.13. This inevitably means that labour costs are one of the key areas targeted for cuts in expenditure. A recent example of this was when CVC and Permira bought out the Automobile Association in a £1.75bn deal. 3,400 staff – equivalent to 34% of the workforce – lost their jobs; the company was loaded with £1.9bn of debt with virtually no assets. The company has since admitted that it cut jobs too quickly and could not operate a consistent service with the staff it had left – this is no consolation to the 3,400 staff made redundant under extremely provocative conditions.

5.14. Amicus would also like to see an exploration of the possibility to modify the present Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE). At present TUPE does not cover situations where undertakings are transferred through share purchases. Transfers that do fall under TUPE are subject to the prior disclosure of relevant company information to employee representatives and some protection of the individual employees affected.

## **6. Financial Stability**

6.1. In the debate about private equity many commentators have expressed concern about the wider economic stability of this new form of asset management that relies so heavily on leverage. Amicus is also concerned about this aspect of the model. Amicus does not want to see a return to the vicious economic cycle employed in the late 1980's and 1990's, where interest rates rose, house prices tumbled and many companies owned by private equity groups failed and closed, with the loss of thousands of jobs.

6.2. In most cases the huge financial returns to be made are seen by the private equity companies as worth the initial extensive financial risk. However there are some examples of companies that have been taken over by private equity companies and have either been bled dry to pay the loans or have proved resistant to any creative restructuring and have been forced to close. The largest UK buy-out failures between 1986 – 2005 were Magnet, bought out in 1989 for £630m and went into receivership in 1992 and Lowndes Queensway bought out in 1988 for £446m which went into receivership in 1990<sup>8</sup>

6.3. Both the European Central Bank (ECB) and the International Monetary Fund (IMF) have expressed disquiet over the rise in private equity activity and especially the level of leverage incurred. They have both

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<sup>7</sup> Amicus - The Future of Manufacturing 2006, Foreign Investment and Ownership in the UK, p.14.

<sup>8</sup> Management Buy-outs 1986-2006, Mike Wright et al, Centre for management Buy-out research, University of Nottingham, June 2006, p 17.

mentioned that this level of debt is unsustainable and needs to be seriously considered. The ECB has conjectured that with such large amounts of debt in companies reducing their liquidity this could have a seriously adverse affect on the wider economic markets if anything untoward should happen globally.

6.4. The International Monetary Fund commented, 'There are risks to the baseline economic outlook, and the balance of risks is now slanted to the downside. A key risk is a greater probability that global growth may falter, whether because of tighter monetary policy, geopolitical turmoil or a greater than expected cooling of the US housing market'<sup>9</sup>

6.5. The Bank of England has also commented, 'benign macroeconomic conditions have helped keep insolvencies and write-offs on banks' corporate exposures at very low levels. But re-leveraging is taking place rapidly in some parts of the corporate sector....indeed, the threat of leveraged buy-outs often involving private equity firms, may be encouraging a widening and deepening of corporate leverage'<sup>10</sup> Amicus believes this exposure to risk is unacceptable and that the Bank of England, the Financial Services Authority and the Treasury have a responsibility to review any risk this volume of leverage could present to the UK economy.

6.6. Amicus believes that the management of systematic risk can be achieved through the introduction of improved requirements for national regulations to improve reporting procedures. Amicus would prefer an EU regulation to encourage a level playing field within the European Union.

6.7. Amicus would also want to see the European Union create a framework to allow private equity companies to be rated according to investment strategy and risk with the European Central Bank as the central arbiter of failures to comply or reveal. This information would then be open to all European Union stakeholders.

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**9<sup>th</sup> May 2007**

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<sup>9</sup> International Monetary Fund, Assessing Global Financial Risks, p. 4

<sup>10</sup> Bank of England Financial Stability Report 2006, Section 3, Prospects for the UK Financial System, p.39.