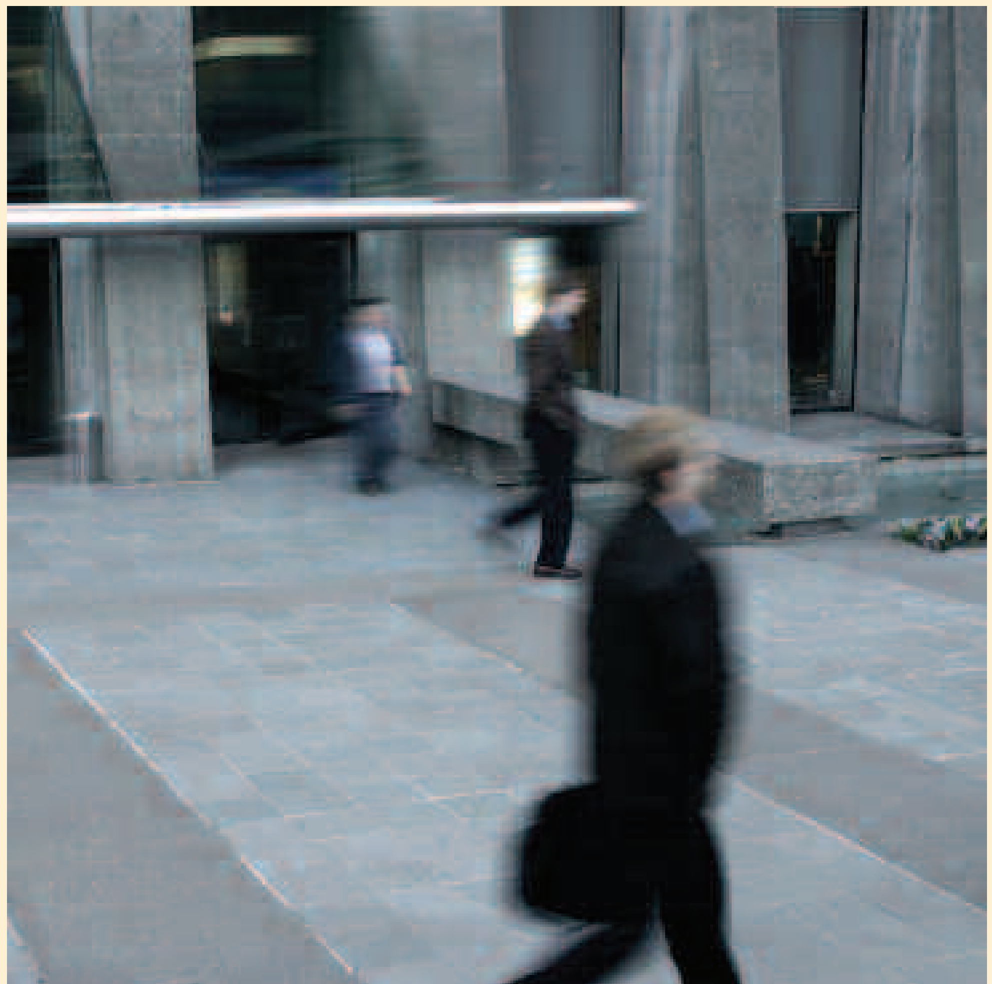
European Foundation for the Improvement of Living and Working Conditions

# The impact of investment funds on restructuring practices and employment levels



# The impact of investment funds on restructuring practices and employment levels

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# Foreword

Globalisation and the rapid developments in financial markets have given rise to new financial instruments and new forms of corporate ownership. This has raised questions about the implications of these for national economies and societies, and for companies in particular. Do new forms of corporate ownership influence employment levels, approaches taken to restructuring, and systems of industrial relations? So-called alternative investment funds (AIFs) have been at the centre of debate for some time. Some commentators maintain that hedge funds, private equity and sovereign wealth funds help ailing companies back onto a growth path, thus ultimately contributing to an increase in employment. However, others claim that the funds' purpose – maximising returns – is achieved at the expense of labour.

Eurofound has carried out substantial research into the financial services sector and its projected future in the wake of the financial and economic crises. This report – part of this package – presents a literature review and looks in detail at the situation in seven European countries. For each country, three cases are examined in depth, exploring the relationship between investment funds and the companies they are involved in. The focus is on the labour outcomes resulting from investment-fund involvement.

The debate on the impact of investment funds has resulted in calls to regulate such funds at both the national and international level. A European Directive on Alternative Investment Funds is currently under discussion. Given that the evidence base for assessing the effects of these funds remains weak and controversial, we trust that this report will provide new evidence assisting policy makers in making decisions on this complex and dynamic issue.

Juan Menéndez-Valdés
*Director*

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# Executive summary

## Introduction

Investment funds have increased in number and become more important to the global economy in recent years. Europe is no exception. The term 'investment fund' refers to private equity (PE), hedge funds (HFs), and sovereign wealth funds (SWFs) – sometimes also referred to as alternative investment funds (AIFs). Although these funds have some common features, they differ in important respects – such as investment strategies, time horizons and extent of ownership of their investment targets.

Investment funds are still small in comparison with other types of institutional investors such as pension funds, mutual funds and insurance funds. However, their greater direct influence on companies and the rise in activity by these funds has led to heated debates on their impact on restructuring practices, employment levels and industrial relations at the firms they invest in. Fund managers have claimed that they play a valuable role in reviving underperforming companies, thereby contributing to long-term employment growth. By contrast, many employee representatives and those on the political left have argued that these new funds concentrate on maximising financial returns at the expense of labour.

This study analyses both sides of the argument. It includes an extensive literature review, a national overview of investment fund activities in several key countries, and a presentation of the views of the social partners and relevant peak organisations in Europe. Case studies of 24 companies affected by investment fund activity, from seven countries across Europe, are presented in an annex published online.

## Policy context

Although discussions about regulating hedge and private equity funds have taken place at European level for many years, the financial crisis focused attention on the regulation of financial activities in general and on AIFs in particular.

With regard to the regulation of investment funds on a European level, in 2009 the European Commission proposed a Directive on Alternative Investment Fund Managers (AIFMs) 'with the objective of creating a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level.' One of the core proposals in this Directive is that funds managing investments above a certain threshold should disclose more information about structure, strategy and investors. The intention was to create new regulatory standards and to improve the transparency of funds for investors and public authorities.

The Directive adopts an approach that does not regulate the different AIFs themselves, but is aimed at the managers of these funds. The latter are seen as responsible for all key decisions in relation to the management of the fund.

In 2010, the scope of the Directive was extended to cover not only funds based in the EU but also funds based outside the EU that distribute their financial products within the Union.

## Key findings

Investment funds have become important actors in Europe, albeit with significant differences between the different types of investment funds. PE tends to be associated with the highest degree of restructuring activity due to its typical acquisition of a majority stake and its objective of gains over the medium term. SWF investments tend to be associated with the lowest level of restructuring due to a longer-term approach to investment and, possibly, because of the desire to avoid public controversy. In between are

activist HFs, which generally only acquire minority stakes and attempt to implement relatively simple changes through a strategic redirection of target companies.

The labour outcomes as a result of investment fund activity vary widely from company to company, with the potential of both positive and negative impacts on labour. Overall, the balance of evidence suggests that PE has more effect on firms and their employees. Activist HFs tend to have less effect, though in some cases successful HF activism can trigger major changes. In the case of SWFs, minority investment and passive ownership has had least effect, but where a SWF acquires a large block of shares or acquires a firm outright this has the potential to strongly affect corporate strategy.

In terms of work organisation, investment fund activities tend to have little effect.

In the case of industrial relations, the case studies indicate that AIF activity produces little change. Employees are seldom informed or consulted when a fund intervenes or acquires a company, but the advent of a fund does not seem to have negative effects on union recognition and membership and the dealings between funds and their workforces have overall been cooperative. However, there are exceptions to this across and within countries. Once firms have been acquired by funds where there are statutory and customary rights to information, consultation and codetermination, these seem to have been respected. In many cases employee representatives have been involved in restructuring decisions to the extent that existing regulation and company traditions allow.

Regulation and institutions matter as mediators of investment fund activities on labour outcomes. Labour regulation does not deter funds from intervening in a firm and is not inconsistent with corporate restructuring. However, labour regulation does give employees a voice and does affect outcomes in ways favourable to employees.

The evidence on the role of national regulation is mixed. Variations in employment protection regulation do not inhibit fund-acquired companies from undertaking large-scale restructuring. However, national regulations affecting employee voice and worker representation do appear to affect the extent to which employee representatives are informed and consulted in post-acquisition restructuring, if not during the acquisition itself.

The financial and economic crisis since 2007 has had an effect on the number and value of fund interventions and acquisitions. As yet, it is unclear whether firms owned by funds will have fared better or worse in the crisis. Already, however, there are some signs that funds may be expanding.

Overall, the study indicates that investment funds are neither wholly bad or wholly good in terms of the impacts on labour in their invested firms. In most cases the funds are committed to ‘growing the business’, with restructuring seen as laying the foundations for this, but the activities of these funds can create uncertainties over job transfers, possible future sales, and divestments.

## Pointers for further research

There are still major gaps in knowledge about AIFs and their impact on employment. Cross-national data, especially statistics, on these types of owners and on the companies they invest in is scarce. Survey information covering the views of both managers and employees and their representatives on employment and labour outcomes would be extremely useful. Also, for a proper evaluation, a sufficiently long time period is desirable. A longitudinal study comparing fund cases with appropriate non-fund cases could bring valuable insights. Lastly, on PE in particular, exploring origin-country effects

and effects resulting from differences in the size and financing structure of deals would increase our understanding of the factors that influence the outcomes in terms of restructuring practices and employment levels.

## Further information

The report on The impact of investment funds on restructuring practices and employment levels is available online at www.eurofound.europa.eu/publications/htmlfiles/ef1064.htm.

For more information, please contact Donald Storrie at dst@eurofound.europa.eu.

# Introduction

## Objectives of the report

One feature of the global economy in recent years has been the increasing number and importance of new investment funds (private equity (PE), hedge funds (HFs) and sovereign wealth funds (SWFs)), which are sometimes referred to as alternative investment funds (AIFs).[1] This increase has paralleled fundamental changes in financial markets and has generated heated debates on the impact of these funds on restructuring practices, employment levels and industrial relations. Fund managers have claimed that they play a valuable role in rejuvenating underperforming companies, thereby contributing to long-term employment growth. By contrast, many employee representatives and those on the political left have argued that these new funds secure returns at the expense of labour.

However, the evidence base for assessing the effects of these AIFs on labour outcomes remains controversial. Therefore, in 2009 Eurofound included the issue of the impact of new forms of ownership and governance on employment in its new programme, Social Dialogue and the Employment Relationship: Evolution in European and National Industrial Relations Systems. The programme states that

> developments in financial markets (more specifically private equity, hedge funds, and sovereign wealth funds, hereafter mainly referred to as investment funds) have given rise to new forms of corporate ownership. The mode of ownership can be expected to have a significant impact on the relationships between all stakeholders within and outside the firm. They almost certainly have consequences for a wide range of employment and social outcomes. These employment and social outcomes include working conditions, social dialogue, human resource practices, restructuring practices, and the overall level of employment. The impact of investment funds is likely to vary between Member States, depending upon both the regulation of the funds themselves and the particular labour market and industrial relations context in the States in which they operate.[2]

This report presents the results of a project that brought together researchers from several European countries to assess the effects of investment funds on labour outcomes.[3] The project has a number of objectives and research questions. The first is to clarify the nature of three relatively new forms of investment fund: PE, HFs and SWFs. The second objective is to consider the possible relationship between these investment funds and various labour and social outcomes, including employment levels, work organisation and employee voice systems within the firms in which funds invest. This also includes considering the views of the social partners and relevant peak organisations in Europe, namely the representatives of employers, trade unions and funds themselves. The third objective is to consider whether there is variation across European countries in the impact on labour outcomes. This involves assessing whether financial market regulation and labour market regulation act as mediating factors, shaping such outcomes. A related question concerns the effects of the financial and economic crisis since 2007 on funds and on labour outcomes. The final objective is to identify gaps in our knowledge and recommend future research options, taking into account recent policy discussions within the EU.

## Background context

The economic background to any study on new investment funds is complex and dynamic. In recent years, there have been a number of developments and innovations in finance with major implications

[1] For the purposes of this report, the term AIF refers only to PE, HFs and SWFs. In political discussion a much broader definition is often used, including many other types of funds.

[2] Eurofound research programme 2009.

[3] This report builds on two earlier studies by the researchers for the European Commission (Wilke et al, 2009 and Voss et al, 2009).

for national economies and societies. This has included the globalisation of financial markets, the development of new financial devices and instruments and the entry of new market participants. As part of this, there has been a growth of PE, HFs and SWFs. All of these have predecessors and origins which go back beyond the last two decades, but, as discussed in Section 1, the number of funds have grown tremendously in size and coverage over the past two decades. In response to their growth, national governments and international agencies have been concerned about the effects, both positive and negative, which they may have on economies and societies. The social partners, employers and trade unions, have been heavily involved in such debates in Europe and other regions. This has resulted in proposals to regulate such funds at both national and international level.

## Methodological remarks

Four different methodological approaches were used to research the effects of funds on restructuring practices and employment levels. First, the existing literature on investment fund activity was reviewed, both generally and more specifically as it affects employment and labour. This review considered various reports by governments, intergovernmental agencies, the social partners and industry bodies. It also considered the academic research literature, including both individual case studies and larger statistical studies. Second, seven country case studies were carried out, covering a spread of countries – the UK, Germany, Italy, the Netherlands, Sweden, Poland and Hungary, using national country correspondents. These case studies are based on primary and secondary data and, where feasible, interviews with key actors. Two brief overviews of the US and Japan, written by the research team, are also included. Third, at least three company case studies were carried out within each country, involving situations where funds have invested in companies. The fourth step was conducting interviews of representatives of funds and peak organisations and employers and trade unions at European level.

However, a number of methodological reservations should be noted. First, although the selected countries are typical of a variety of contexts within Europe, the research does not cover Europe in its entirety. Second, the available data varies considerably in quantity and quality for the different types of funds, countries and company cases. The best data exist for PE but, even then, only for certain countries. There are much less data on how HFs and SWFs have affected employment and labour outcomes. Third, even where data exist and even where appropriate statistical techniques can be used, there are still problems of interpretation. There are difficulties relating cause and effect, identifying suitable control cases and dealing with the counterfactual (i.e. what might have happened to an acquired company in the absence of intervention by an investment fund).

## Structure of the report

Section 1 outlines the ways in which PE, HFs and SWFs work and provides a brief overview of their size and coverage. Section 2 considers the purported links between these various funds and labour outcomes, including employment levels, work organisation and employee voice systems. Section 3 reviews the existing research literature on the effects of AIFs on outcomes and considers the mediating effect of labour and capital market regulation. Section 4 contains the country case studies, prepared by the national correspondents, from the UK, Germany, Italy, the Netherlands, Sweden, Poland and Hungary. The main findings from the company case studies have been integrated into these country reports. Because of length constraints, the complete company case studies are not included in this report, but can be found on the Eurofound website at www.eurofound.europa.eu. In Section 5 the country and company information is analysed along with other available evidence which has been surveyed. In Section 6 the current debate over the proposed Directive on Alternative Investment Fund Managers is discussed and the views of the peak organisations outlined. The final section draws some broad conclusions about what is already known and what might be the subject of further research.

# Analysing new investment funds 1

## Background: The nature and extent of investment funds

This report focuses on the activities of three different types of investment fund: PE, HFs and SWFs. Although these funds share some common features, they differ in important respects, such as investment strategies, time horizons and extent of ownership in their investment targets. Each type acquires ownership stakes in portfolio companies, but the size of these stakes differs considerably between fund types. The extent and nature of governance exerted by these funds, and thus their effects on portfolio companies, also differs. Investment styles and strategies also vary considerably.[4]

Overall, the size and importance of these funds has increased greatly in recent years, though PE and HFs have seen falls in activity and assets under management since the onset of the financial crisis in 2007. It should be noted that they are still small in comparison to other types of institutional investors such as pension funds, mutual funds and insurance funds. However, their impact and significance have been disproportionate because of the nature of their investment and governance strategies and their greater direct impact on companies.

This section outlines the core features of each fund type and its typical investment strategy. Details are provided on the incidence and distribution of funds. This provides the foundation for the discussion in Section 2 on the possible linkages between funds and labour outcomes.

## Private equity

PE usually refers to equity investments in companies that are not listed on stock exchanges and hence do not have publicly traded shares. PE funds typically invite subscriptions from wealthy individuals and institutional investors, usually for a set period of time – the lifetime of the fund. These investors become limited partners in the fund. Institutional investors (pension funds, mutual funds and insurance companies) have invested increasingly in PE in recent years because PE funds typically offer the opportunity to earn high, though risky, returns. The general partners who manage the fund charge investors an annual management fee (typically 2%) and take 20% of the annual returns of the fund above a pre-agreed 'hurdle' rate of return payable to investors (so-called carried interest) (Gilligan and Wright, 2008). Useful summaries of the features of PE can be found in the following: Folkman et al (2009), Gilligan and Wright (2008), House of Commons Treasury Select Committee (2007), PSE Group (2007) and Watt (2008).

This pooling of capital is used to acquire existing companies with a view to restructuring their operations prior to a later resale or stock market flotation some five years later (though this can sometimes be shorter or longer). In some cases, publicly listed firms are acquired by PE and made private. The capital raised is put into an acquisition vehicle which then acquires the target company. Typically, over half of the purchase price is met by loans, most of which are secured against the assets of the company being acquired, with the remainder contributed by the PE fund. In the past, these loans tended to be supplied by banks, but increasingly they are supplied by other investment funds, such as HFs and sometimes SWFs. PE funds, either singly or in conjunction with other PE funds, usually acquire target companies in their entirety. The whole process is shown diagrammatically in Figure 1.

Unlike most institutional investors in equity markets (pension funds, insurance companies and mutual funds), PE funds generally take a highly activist approach to their investee companies. They are able to do so because they have total or large ownership stakes in their targets. The top managers of these

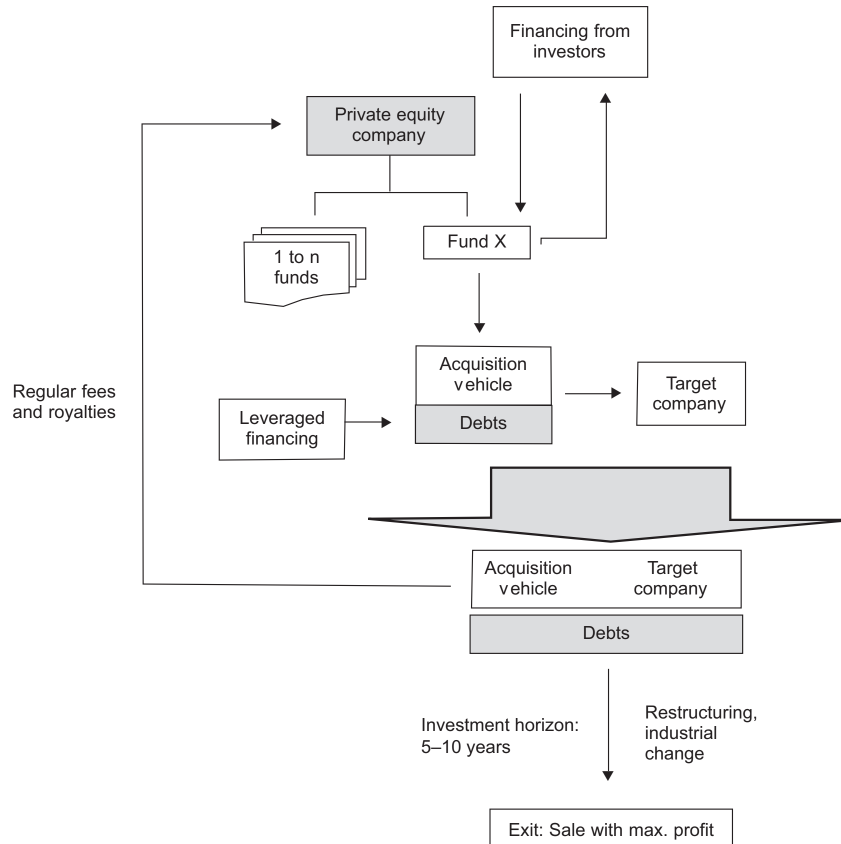
[4] For a more detailed analysis of the different strategies for PE and HFs, see Achleitner (2005).

targets, often newly installed by the PE fund, are monitored closely and their incentives tied to the achievement of restructuring goals. These managers are typically provided with equity-based incentives and may contribute a portion of the purchase price.

PE firms have a variety of acquisition targets: they include companies in their entirety and divestments of product divisions and subsidiaries of larger companies. Some of the most dramatic cases have been public-to-private transactions, whereby large listed companies are taken into private ownership (e.g. Boots in the UK or Gambro AB in Sweden). These targets of PE funds can be distinguished from so-called venture capital (VC) or seed investments in small start-up companies, which are not covered in this study.

Four sources of gain can be identified (Watt, 2008). First, there may be genuine improvements in performance arising from better management, new strategies and improvements in methods of value creation. Second, there may be value transfers from government and taxpayers arising from financial engineering – the use of debt-limiting corporation tax, lower capital gains replacing higher income tax and the transfer of profits abroad. Third, there may be transfers from other capitalists, i.e. acquiring good companies at low prices and selling them at inflated prices. Value transfers from debtholders may also take place as the probability of bankruptcy typically increases with increasing leverage and the value of existing debt decreases. Finally, there may be value transfers from employees first to the company and later to the investors.

**Figure 1 How private equity works**




Source: *Based on ATKearney, 2006*

In principle, a PE buyout can be aimed at achieving gains via any of these four routes or combinations of them. Trade union critics argue that gains are mainly made at the expense of workers and taxpayers. Others emphasise the role of financial engineering as the primary source of gain, at least when credit was more readily available prior to the recent crisis (Folkman et al, 2009). By contrast, the PE industry has argued that the main source of gain has been real value creation. On balance, econometric studies show that a combination of factors explain PE returns. As will be discussed further below, Achleitner et al (2010) find that one-third of PE returns in Europe can be explained by leverage or debt borrowings and two-thirds by market timing and operational factors. Guo et al (2009) find that PE returns are driven as much by tax advantages and increases in company valuations as by operational improvements.

It has also been suggested that short-termist perspectives of PE funds intensify the pressures on investee firms to pay back debt and undertake restructuring. However, it is not clear that PE funds are short-termist in comparison with many other investors, and many PE funds claim to be comparatively long-term investors. The typical timeframe for ownership is five years as a result of the closed-end nature of most PE funds. Stromberg (2007) found that the median PE-owned firm is still in PE ownership nine years after the buyout, and it is argued that holding periods have not become shorter since the 1990s (Kaplan and Stromberg, 2009).

A notable feature of PE funds is that, for the size of their operations, they are relatively unregulated and have fewer obligations to disclose than other types of investment funds, such as pension funds. Moreover, as they do not seek investors on the retail market, they are not covered by regulations governing the sale of investment products. As private companies, PE-owned businesses are generally exempt from the disclosure and corporate governance requirements faced by stock market-listed firms. The lack of disclosure can present problems for employees and their representatives in responding to managerial restructuring initiatives and, indeed, in responding to PE takeovers. In this respect and in relation to this study, it is important to note that PE takeovers, as share transactions, may not be viewed as a change of control which triggers employee rights to information and employment protection under the EU Directive on Safeguarding Employee Rights in the Event of Transfer of Undertakings.[5]

In 2008 PE funds globally had approximately USD 2,000 billion (€1,363 billion as at 1 September 2008) under management. As already stated, this is a relatively small amount (about 3%) compared to that held by institutional investors, but until the recent financial crash, the volume and importance of PE investment was growing. Moreover, institutional investors have themselves increasingly invested in PE to achieve higher returns than are typically obtained from stock market investments. The largest PE funds by volume of capital raised are shown in Table 1. As the table shows, the largest funds are based either in the US or UK.

[5] 2001/23/EC. This replaces Directives 77/187/EC (the Acquired Rights Directive) and 98/50/EC.

**Table 1 Top 20 PE firms by capital raised, 2003–2008**

| Fund name | Country | Capital raised over the last five years (1 January 2003 – 15 April 2008, USD billion) |
|---|---|---|
| The Carlyle Group | US | 52.00 |
| Goldman Sachs Principal Investment Area | US | 49.05 |
| Texas Pacific Group | US | 48.75 |
| Kohlberg Kravis Roberts (KKR) | US | 39.67 |
| CVC Capital Partners | UK | 36.84 |
| Apollo Management | US | 32.82 |
| Bain Capital | US | 31.71 |
| Permira | UK | 25.43 |
| Apax Partners | UK | 25.23 |
| The Blackstone Group | US | 23.30 |
| Warburg Pincus | UK | 23.00 |
| 3i Group | UK | 22.98 |
| Advent International | US | 18.32 |
| Terra Firma Capital Partners | UK | 17.00 |
| American Capital | US | 17.00 |
| Providence Equity Partners | US | 16.36 |
| Silver Lake | US | 15.60 |
| Cerberus Capital Management | US | 14.90 |
| AIG Investments | US | 14.22 |
| Fortress Investment Group | US | 14.00 |

Source: *Private Equity International Magazine*, http://www.peimedia.com/resources/PEI50/PEI-50_executivesummary.pdf

In recent years, Europe has become an increasingly attractive market for PE deals. Earlier, in the buyout boom of the late 1980s, most buyout activity by value was in the US, with just 10% occurring in Europe (of which most was in the UK). By contrast, between 2000 and 2005, 49% of activity by value took place in the UK and western Europe, with most of the growth outside the UK (Kaplan and Stromberg, 2009: 127). Bernstein et al (2010), in a study of PE across the OECD (using the Capital IQ database of PE transactions), found that PE activity is concentrated in the US, UK, Sweden and the Netherlands. Hungary is also an important site of PE activity in Europe (Watt, 2008). Most of the PE activity in Europe is undertaken by PE funds based in the UK or US (Watt, 2008). Table 2 shows the relative importance of PE in the European countries studied in this report.

**Table 2 Private equity and buyouts in the selected countries, 2009**

| | United Kingdom | Germany | Netherlands | Sweden | Italy | Poland | Hungary |
|---|---|---|---|---|---|---|---|
| Investments (% of GDP) | 0.41 | 0.10 | 0.27 | 0.24 | 0.13 | n/a | n/a |
| Number of investments | 377 | 84 | 59 | 33 | 22 | 8 | 3 |
| Investments (€ million) | 6,294 | 2,049 | 1,291 | 591 | 1,685 | 267 | 233 |
| Average deal size | 17 | 24 | 22 | 18 | 77 | 33 | 78 |
| >€500 million (#) | 2 | 0 | 1 | 1 | 0 | 0 | 0 |

Source: *MBOR, Wright et al (2007)*

## Hedge funds

There is no single definition of a hedge fund and there is considerable variety in the investment strategies operated by such funds. There are four characteristics common to HFs: they are pooled, privately organised alternative investment vehicles which can invest in all kinds of assets; they are not widely available to the public; they are run by professional investment managers who often have significant own investments in the fund and are paid on a performance basis; and they operate largely outside of securities regulation and registration requirements (see Brav et al, 2008: 1,735). As such, they are usually exempt from the requirement typically faced by mutual and insurance funds to hold diversified portfolios. The focus of HF activity may include equities, commodities, currencies, debt instruments and derivatives.

This report focuses on HFs which invest in equity and buy company shares directly. Here the most important investment approaches from the point of view of potential employment effects are funds which follow so-called (1) directional, (2) event-driven and (3) activist strategies.

In directional approaches, HFs seek margins by exploiting, and possibly even causing, market movements. The best-known version of this approach is short-selling. Here HFs sell shares which they borrow from other investors in the expectation that the stock price will fall; they then repurchase them at a later, lower price, thereby earning the difference in share price between sale and repurchase (minus the costs of 'borrowing' the shares). This can put strong pressure on firms, which may have employment consequences. Event-driven strategies secure returns through interventions in particular situations such as mergers and acquisitions (M&A) (taking advantage of the share premium that usually arises in such situations) or in distress and bankruptcy situations. Over time, event-driven strategies have grown in number. One of the case studies in the attachment to this report (the acquisition of Cadbury by Kraft) deals with an event-driven situation. Activist HFs try to influence management and company strategies to enhance the returns accruing to shareholders by putting public pressure on managers (Achleitner et al, 2009). Among the company case studies, Cadbury in the UK, Cewe Color in Germany and ABM Amro in the Netherlands have elements of activist involvement.

Like PE, HF activism is aimed at strategic redirection of target companies. However, unlike PE, activist HFs rarely secure controlling stakes (Brav et al, 2008). They usually rely on cooperation with the existing management and shareholders. However, some of the most visible cases have been those where a HF contests the incumbent managers.[6]

[6] For Germany, see the recent case of the German Stock Exchange as well as other examples in Voss et al (2009) and Bessler and Holler (2008). For the UK, see the boardroom battle over the leisure company M&B.

Focusing on those HFs which pursue activist strategies, three sources of returns can be identified (Fichtner, 2009): exploitation of market mispricing; increases in market value through improvements in management, processes and products; and value transfers from other stakeholders, such as employees. In these respects, the objectives and activities of activist HFs are similar to PE funds, with the primary difference being that HFs hold smaller stakes and as a rule focus their activities on listed firms. However, in specific cases HFs may acquire bad debt and distressed securities with the ultimate goal of gaining control of these companies.[7]

Using German examples, Fichtner (2009) identifies three main strategies pursued by activist HFs, all of which can affect employees. First, there may be pressure on investee companies to initiate share buy-backs, thereby delivering cash to investors and enhancing the value of remaining shares. This limits free cash flow, thereby imposing further discipline on managers and arguably restricting the resources that might be paid to employees.[8] Second, there may be payments of special dividends to shareholders. This has the same effect on cash flow, and companies may take on debt to finance these dividends – this has the added effect of further controlling cash flow and imposing yet more discipline on managers. Third, there may be the sale (or closure) of product divisions or subsidiaries seen as ancillary to the core business of the company. In terms of numbers, Fichtner (2009) found that between 2001 and 2009, out of 10 listed German examples, one paid a special dividend, four sold divisions and six initiated share buy-backs in response to HF pressures.

In a study of 1,059 instances of US HF activism over the period 2001 to 2006, Brav et al (2008) found that interventions are motivated by five main objectives: to correct and exploit general undervaluation, modify capital structure, reform business strategy, sell the target and achieve governance reforms. Other evidence suggests that HFs tend to focus more often on value transfers than changes to business and operating strategies (Klein and Zur, 2009a). Interventions are usually aimed at initiating share buy-backs, initiating cash dividends, cutting CEO pay and securing board seats. The evidence suggests that they are frequently successful in these aims. The success rate for campaigns to change business strategies, to oppose mergers or to sell the firm is around 50%.

In 2009, the number of HFs worldwide was estimated at around 7,000, having declined somewhat from a peak of over 7,500 in 2007, and with over USD 1,000 billion under management (Alpha Magazines Hedge Fund 100, 2009; Charles Rivers Associates, 2010). The US is the largest international centre for HFs and most of the largest HFs are American. Outside the US, London is the second largest international centre for operations. In Europe, Paris and Dublin have also established themselves as secondary centres for HF headquarters. However, HFs are typically registered in offshore centres, with the Cayman Islands, Bermuda and the British Virgin Islands being especially important centres. It is not clear how many HFs follow an activist investment strategy in equity, but there is evidence that only a minority of HFs are active in this field. Table 3 shows the 20 largest HFs by assets under management.

[7] There are several examples of such HF activites. For Germany, see the case of Schefenacker in Wilke et al, 2009.
[8] Share buy-backs can also be a company-initiated strategy for shaking out HF investors who are betting on declines in share value.

**Table 3 Top 20 HFs by assets under management in 2009**

| | Firm | Capital USD millions |
|---|---|---|
| 1 | Bridgewater Associates (Westport, CT) | 38,600 |
| 2 | J. P. Morgan Asset Management (New York, NY) | 32,893 |
| 3 | Paulson & Co. (New York, NY) | 29,000 |
| 4 | D.E. Shaw & Co. (New York, NY) | 28,600 |
| 5 | Brevan Howard Asset Management (London, UK)* | 26,840 |
| 6 | Man Investments (London, UK) | 24,400 |
| 7 | Och-Ziff Capital Management Group (New York, NY) | 22,100 |
| 8 | Soros Fund Management (New York, NY)* | 21,000 |
| 9 | Goldman Sachs Asset Management (New York, NY)* | 20,585 |
| 10 | Farallon Capital Management (San Francisco, CA)** | 20,000 |
| 11 | Renaissance Technologies Corporation (East Setauket, NY)** | 20,000 |
| 12 | Barclays Global Investors (London, UK) ** | 17,000 |
| 13 | Baupost Group (Boston, MA) | 16,800 |
| 14 | BlueBay Asset Management (London, UK) | 16,700 |
| 15 | Moore Capital Management (New York, NY) | 16,500 |
| 16 | Avenue Capital Group (New York, NY)* | 16,204 |
| 17 | King Street Capital Management (New York, NY) | 15,900 |
| 18 | Angelo, Gordon & Co. (New York, NY) | 14,000 |
| 19 | Fortress Investment Group (New York, NY) | 13,661 |
| 20 | BlueCrest Capital Management (London, UK) | 13,273 |

Source: *Alpha Magazines Hedge Fund 100 (2009)*
* Capital is as of 31 December and excludes double-counted assets in funds.
** Capital is as of 31 December.
*** 2009 AUM Alpha Estimates and Net Return Alpha Estimate

Most of the empirical evidence on the activities of HFs is from the US. This evidence indicates that activist HFs target firms that are undervalued but nevertheless performing well. Such firms also tend to have governance problems, which may well impede higher valuations. Brav et al (2008) find that HFs target 'value' firms (i.e. those with low market to book value) which have a sound cash flow and good return on assets (ROA). However, targeted firms tend to pay lower returns to shareholders, pay their CEOs more and have more takeover defences. Similarly, Klein and Zur (2009a) and Clifford (2008) find that activist HFs target better-performing firms with higher profitability.

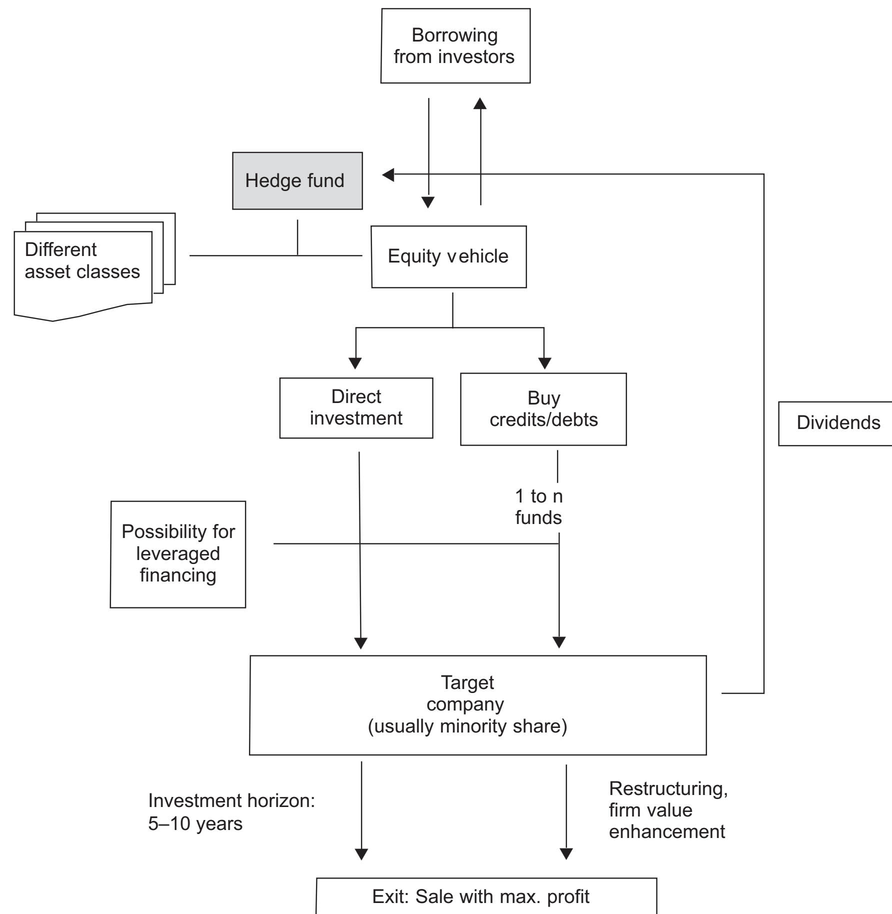
Briggs (2007) studied all known cases of HF activity in 2005 to 2006 in the US. Only 49 companies were direct targets of significant public campaigns. Just five involved HFs with less than a 4.9% stake (5% is the critical level for disclosure of ownership stakes in the US). This study indicates that securing board seats is a major objective, even though this requires HFs to adopt fiduciary responsibilities and converts them into something more like longer-term investors.[9]

[9] Under US securities law, these HFs cannot freely sell these shares because their 5% holding makes them an affiliate.

US evidence indicates that stock markets respond favourably to HF interventions (Boyson and Mooradian, 2007; Brav et al, 2008; Greenwood and Schor, 2009; Klein and Zur, 2006 and 2009b; Ryan, 2006). For example, Brav et al find that the market responds most positively to company sales or changes in strategy. However, Greenwood and Schor (2009) argue that gains are driven by the potential that the target company will be taken over by another company with a purchase premium; targets which are not taken over have no significant abnormal gains after one year. Stockman's (2007) study of HFs in the US and Europe finds significant abnormal stock market returns around the intervention date. He also finds positive abnormal returns over a longer period (six months) but this then declines. Ryan (2006) finds the largest abnormal returns were where targets have underperforming shares and strong cash flow and where there are significant holdings by HFs.

The evidence regarding operative performance after the intervention of the HF is mixed. Clifford (2008) finds that there is improvement in return on assets and greater asset divestments in firms targeted by activist investors compared with passive HF investors. Boyson and Mooradian (2007) and Brav et al (2008) find modest improvements in profitability; the latter find a large increase in CEO turnover at targets. However, Klein and Zur (2006 and 2009a) find a decrease in profitability and cash and an increase in dividend payouts and debt levels at targets. In a further study, Klein and Zur (2009b) find that the value of bonds and the quality of credit ratings at target firms decrease, suggesting that at least some shareholder gains come at the expense of bondholders.

**Figure 2 How hedge funds work**




Source: *Based on ATKearney, 2006*

## Sovereign wealth funds

SWFs are investment funds owned and operated by governments or their agencies. The Sovereign Wealth Fund Institute defines them as funds which acquire and administer assets to achieve national financial objectives and which employ a set of investment strategies including investing in foreign financial assets (IFSL, 2009). Thus, SWFs are used by countries with excess foreign reserves to obtain a higher rate of return on their assets than would be available from the issue of government bonds or domestic assets (Sethi, 2008: 12). In many countries this capital is generated by the oil industry, but in some cases also by the successful accumulation of non-commodity trade surpluses.

The largest SWFs are based in the United Arab Emirates, Saudi Arabia, Norway, China and Singapore. Table 4 provides details of the 20 largest SWFs by assets under management. Overall, in 2009, assets under management by SWFs increased from under USD 1,000 billion in 1999 to USD 3,800 billion (IFSL, 2010). In 2007, the estimated investing activity of SWFs was approximately USD 33.3 billion. This was an increase of 32% on the previous year and illustrates the rapid growth that has taken place in this type of fund (Bortolotti et al, 2009; Sethi, 2008: 16).

**Table 4 Top 20 SWFs by assets under management (December 2009)**

| Fund name | Country | Assets under management (USD billion | Origin |
|---|---|---|---|
| Abu Dhabi Investment Authority | UEA - Abu Dhabi | 627 | Oil |
| Government Pension Fund – Global | Norway | 445 | Oil |
| SAMA Foreign Holdings | Saudi Arabia | 431 | Oil |
| SAFE Investment Company | China | 347.1 (estimate) | N.C.* |
| China Investment Corporation | China | 288.8 | N.C. |
| Government of Singapore Investment Corporation | Singapore | 247.5 | N.C. |
| Kuwait Investment Authority | Kuwait | 202.8 | Oil |
| National Welfare Fund | Russia | 168 | Oil |
| National Social Security Fund | China | 146.5 | N.C. |
| Hong Kong Monetary Authority Investment Portfolio | China | 139.7 | N.C. |
| Temasek Holdings | Singapore | 122 | N.C. |
| Libyan Investment Authority | Libya | 70 | Oil |
| Qatar Investment Authority | Qatar | 65 | Oil |
| Australian Future Fund | Australia | 49.3 | N.C. |
| Revenue Regulation Fund | Algeria | 47.0 | Oil |
| Kazakhstan National Fund | Kazakhstan | 38 | Oil |
| National Pensions Reserve Fund | Ireland | 30.6 | N.C. |
| Brunei Investment Agency | Brunei | 30 | Oil |
| Strategic Investment Fund | France | 28 | N.C. |
| Korea Investment Corporation | Korea | 27 | N.C. |

* N.C. – Non-commodity; number is a best guess estimation.

Source: *SWF Institute, March 2010*

SWFs take one of two main forms. The largest are generalist funds investing in a wide variety of asset classes (Rehman, 2010: 54). Unlike PE and HFs, they are open-ended and are able to take a long-term perspective. They are more flexible in their investment strategies than institutional investors and make use of a large number of external fund managers (Rehman, 2010: 54). Where they take equity stakes in public companies, their ownership level is usually below public disclosure requirements, and they have been largely quiescent in their approach to governance. Incumbent managements are usually allowed to remain in place and few, if any, demands are made for substantial changes in structures, governance or operations (Sethi, 2008: 13).

Much smaller than the generalist funds are specialist government investment vehicles. These often take strategic stakes in portfolio companies and pursue more activist governance strategies (Rehman, 2010: 65). In some cases they take control of investee firms. In these respects, these funds are more similar to PE firms than generalist funds. Indeed, there is some evidence that some of these smaller funds are beginning to structure themselves on PE lines (Sethi, 2008: 19–20). These funds also invest more substantially in PE, HFs and other higher-risk asset classes than generalist SWFs.

SWF activity in the EU is highly concentrated in the UK (49% of total SWF investment). Germany and the Netherlands also have relatively high levels of activity, Italy is lower and data on the other countries in the study are not readily available. The bulk of SWF investment in Europe in the past few years has been concentrated in large financial institutions.

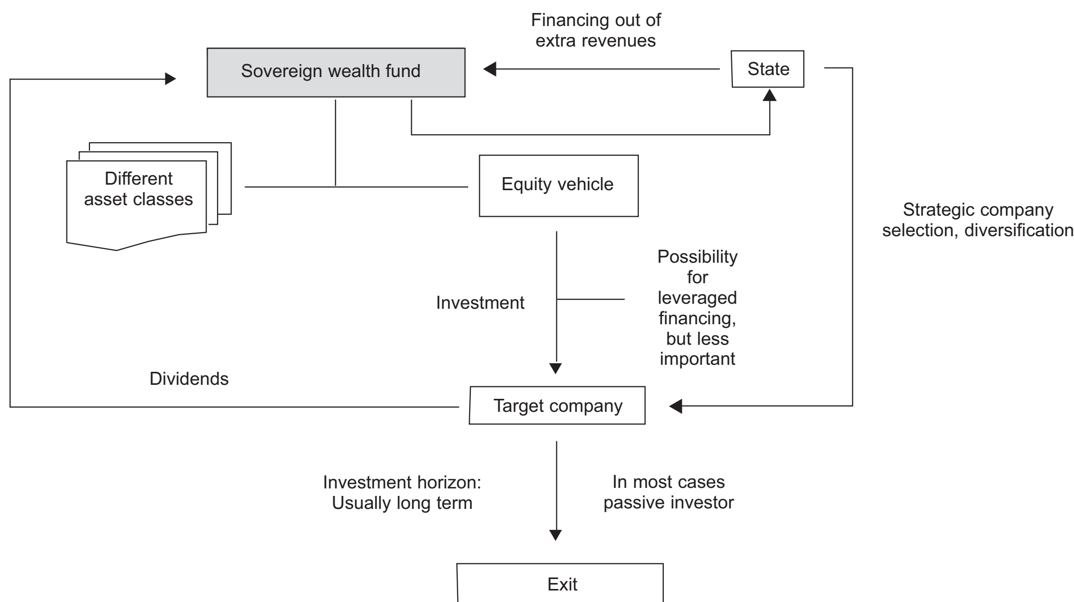
**Table 5 SWF investments into EU countries**

| Target countries of SWF investments in the EU | United Kingdom | Germany | France | Netherlands | Italy | Other |
|---|---|---|---|---|---|---|
| **Completed investment transactions by SWF** (1995 – June 2009), total USD 187 billion | 49% | 15% | 12% | 6% | 4% | 14% |

Source: *IFSL Research (2010): SWFs 2010*

SWFs have given rise to widespread concern because it is argued that they enable overseas governments to acquire important stakes in companies in other countries, thereby offering the potential to exert strategic, but hidden, influence on other countries' economies. They are also said to lack transparency about their holdings, strategies and objectives. They tend to be secretive, are careful not to reveal too much about positions and are conscious of charges of interference. They tend to disclose less information than PE and HFs. Of the larger SWFs only the Norwegian Government Pension Fund makes public detailed reports on its activity and returns. Figure 3 illustrates how SWFs operate.

**Figure 3 How sovereign wealth funds work**




Source: *Based on ATKearney, 2006*

## Comparing fund strategies

This review of PE, HFs and SWFs reveals a number of similarities between the three types of fund, as well as some important differences. The main similarities are that they are large private funds which invest in equity and are relatively lightly regulated, with few obligations to disclose their activities publicly. The main difference between them lies in the size of the ownership stake. PE investments in companies are usually substantial and often comprise a majority of the ownership. HFs, by contrast, usually hold smaller stakes, though in some instances they are relatively large compared with the norm for institutional investors in companies with dispersed ownership. SWFs traditionally held small investments to keep below legal disclosure limits, but there is evidence of a tendency towards taking larger, strategic ownership stakes, especially among specialist SWFs. Activist HFs and SWFs tend to invest in publicly listed companies whereas PE invests in privately owned firms or takes publicly listed firms into private ownership.

Other important dimensions are the extent of fund activism in governance and management and the time horizons of investment funds. PE and HFs typically adopt activist approaches to monitoring their investments, while SWFs for the most part are passive. However, while PE has a strong influence on the strategic direction of portfolio companies via majority ownership, activist HFs rely more on a range of tactics associated with the use of various instruments of shareholder rights, such as proxy contests. Of the three, PE typically has the strongest influence on target company strategies. It is arguable that the governance strategy of PE tends to focus at least in part on value creation (though this has been a highly contentious claim), whereas activist HFs are mainly concerned with value transfer (though the funds themselves argue that they correct market imperfections). The time horizons for returns tend to differ between the three types of fund. PE typically aims to hold its portfolio companies for around five years, to synchronise with the typical lifetime of PE funds. Most of the return to investors comes from the resale of portfolio companies. Activist HFs typically have a shorter time horizon, aiming to secure returns from activism within a year. SWFs have traditionally had the longest time horizons, in line with their generally passive approach to their investments. However, the new breed of specialist SWFs may be focusing on shorter time horizons.

# The issues: Analysing impacts on restructuring and employment levels

2

## The links between investment funds and labour outcomes

The focus in this section is on the possible links between AIFs and labour outcomes. Why might there be such connections? What are the mechanisms which potentially link the different areas? How might these mechanisms be affected by other factors? How might the effects of AIFs differ between types of fund?

Labour outcomes can be clustered in three areas – employment relations, work relations and industrial relations. Employment relations are taken to cover job tenure, pay systems and wage structure, benefit systems and employment levels. Work relations concern how work is organised, the intensity of work, and training and the use of skills. Industrial relations is taken to cover various employee voice arrangements, including information and consultation, board representation, works councils, trade unions and collective bargaining, and broader social dialogue.

The acquisition of shares and the involvement in a company by PE, a HF or a SWF may affect company management and in turn affect labour outcomes through various mechanisms and in various ways. Seen broadly, the advent of new owners may introduce new constraints and new opportunities. In other words, there may be new demands and disciplines on labour which may have adverse effects and threaten jobs, undermine pay and conditions and increase work pressures. On the other hand, there may be new opportunities in terms of job security, higher pay and better benefits in return for more productive work. In the case of both constraints and opportunities, there are various transmission mechanisms which may operate.

First, new owners may affect *time horizons*. As argued in Section 1, HFs tend to have short-term, PE medium-term and SWFs long-term time horizons. The contrast then is with the time horizons of other owners, such as individuals and families, banks and institutions such as mutual, pension and insurance funds. Short-term horizons, with a high propensity to sell, may lead to higher pay-back demands and a disinclination to invest in longer-term, intangible assets, such as human resources (HR). In practice, for example, this may affect job security and preparedness to invest in training. It may also mean that investors with shorter time horizons create mechanisms to intensify work and obtain a quick return on human capital.

Second, new investment fund owners may affect *corporate strategies* in various ways. The acquisition of a sizeable proportion of shares or the total quantity of shares by a new investor may induce firms to expand or contract, to acquire or divest, to pursue greater product market share or financial maximisation. In turn, then, the choice of such strategies will have implications for job security, promotion prospects and pay and benefits.

Third, new owners may affect *performance management* in various ways. They may shift the balance between devices based on traditional commitments and ones based on monetary rewards. They may also shift the balance between performance targets based on production and service quality and targets based on financial returns. Any such shift may then, for example, have implications for the use of different sorts of pay systems and pay structures down through the firm.

Fourth, new owners may shift the *balance in governance and voice systems* within the firm. Thus, new owners may affect the weight of shareholder voice relative to other stakeholders. In terms of employee voice, they may shift the balance between one-to-one direct participation as opposed to representative and collective participation in the firm. Works councils and trade unions may be either favoured or

disfavoured. Of course, in the case of employee representation, as discussed below, national laws and employee preferences are factors which owners and managers have to take into account.

Thus, there are various ways in which investment fund ownership may influence firm-level management behaviour and decision-making. In turn, then, these may affect employment, work and industrial relations.

## The mediating effects of capital and labour market regulation

The relationships between funds, companies and labour outcomes may be influenced by other factors. Two seem especially important: financial market and labour market regulation. Both may mediate the effects of new investment funds on labour outcomes.

Regarding the regulation of capital markets, the following variables need to be considered.

1) **The regulation of investment funds** – including the ease of establishing funds, the ability to use different legal arrangements and the rights of investors in investment funds. This may be important for explaining the different size of the domestic PE and HF industries.
2) **Shareholder rights and duties** – especially for minority shareholders. This will influence in particular the ability of activist HFs to put pressure on incumbent management. This includes the following aspects: how easily can board members be replaced; what proportion of shareholders are needed to call an extraordinary shareholders' meeting; what proportion of shareholders are needed to put items on the agenda; what are the thresholds for disclosing significant shareholdings (including whether indirect ownership must be disclosed)?

Different aspects of tax law may influence investment activity: deductibility of interest payments on debt, which lowers the cost of debt finance relative to equity and therefore encourages the use of debt (e.g. in PE deals and potentially in activist HF pressure on companies to reduce equity and cash levels); the rate of capital gains taxes (CGT), which affects the profitability of deals; differential levels of such taxes depending on whether or not a controlling interest has been acquired; and the taxation treatment of PE managers' investment of private capital (as opposed to managed capital) in PE deals (carried interest).

Constraints on foreign investment (this affects SWFs in particular). In many countries the government has a legal right to veto investments by foreign entities which may acquire a controlling interest. For example, Germany recently strengthened government rights in this area. The use of these rights has been rare, but their existence may have a deterrent effect on SWF attempts to make investments which might be seen as controversial.

Regarding the regulation of labour markets, the following variables need to be considered.

Employment protection legislation is relevant in that its absence/strength will affect the costs and benefits which an investment fund can expect to obtain from any restructuring. Thus, legislation on redundancy will affect the cost of restructuring. It should be noted that in certain countries, such as the UK, PE takeovers, as share transactions, may not be viewed as a change of control which triggers employee rights under the EU Directive on Safeguarding Employee Rights in the Event of Transfer of Undertakings.[10]

[10] 2001/23/EC. This replaces Directives 77/187/EC (the Acquired Rights Directive) and 98/50/EC.

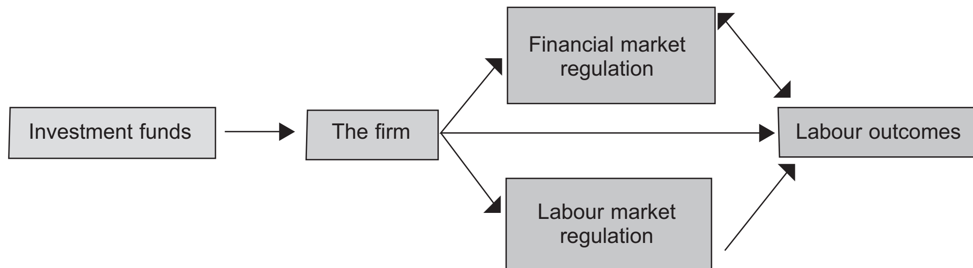
Law on information and consultation: depending on the jurisdiction, this may be relevant and may require employers to disclose details of their activities and plans and to consult employees. In some cases, such as Germany and the Netherlands, this is enshrined in extensive legislation which *inter alia* provides rights for works councils. In other countries, such as the UK, employee rights to be informed and consulted are more limited. On some matters, in some countries, employees may have rights to co-determine certain matters.

Law on employee directors: again in some jurisdictions, such as Germany, the Netherlands and Sweden, employees have the right to a number of seats on company boards, and this can provide significant information and resources which employees may be able to mobilise in the event of an investment fund intervention.

Along with the law, employees may be able to influence the development of fund intervention in a company (to either support or oppose such an intervention) through their trade unions and collective bargaining. Crucially, success in this respect would seem to depend on the effectiveness of the trade union at company-wide level.

A simple framework for explaining the impact of the different factors is depicted in Figure 4. Investment funds acquire shares in firms. They constitute respectively independent and intervening variables. Through the sorts of mechanisms outlined above they may affect the dependent variables under consideration here; that is, employment and labour outcomes. However, the broader financial market and labour market regulatory contexts then mediate these relationships.

**Figure 4 A simple framework**



# Links to labour outcomes: Findings from existing research

3

## Introduction

There is considerable variation in the amount of systematic research evidence on the effects of PE, HFs and SWFs on employees and employment. There is fairly substantial evidence relating to the outcomes of PE transactions, derived from large-scale surveys, accounting records and case study investigations. By contrast, there is very little on the outcomes of activist HFs and SWFs. Much of the evidence on PE is derived from studies conducted in the US and UK, but increasingly evidence is being obtained from other European countries (including some pan-European studies). The results of these studies provide sharply differing evaluations of the impact of PE on employees and employment. This has both reflected and further fuelled political controversies concerning the effects of PE.

## Private equity

### Employment

Most of the evidence on the labour-related impact of PE is on employment levels. There have been several large-scale studies using quantitative data derived from company accounts and company-generated data. In one of the few multinational studies, Bernstein et al (2010) examined the OECD countries and found that industries with high levels of PE activity have higher growth in employment and employment costs. Their results imply that growth in employment and in employment costs partially substitute for each other, suggesting that wage–employment trade-offs may take place. These results are consistent with the idea that PE stimulates growth and value creation in the sectors in which it operates. The limitation of their study, however, is that the attribution of sector effects to PE is somewhat speculative: it could be that firms without PE involvement are driving sectoral employment growth, or that PE is attracted to higher-growth sectors rather than driving higher growth rates.

There are also some large-scale econometric studies from within particular countries. The most comprehensive study of employment effects was conducted in the US by Davis et al in Lerner et al (2008). The study compared around 5,000 PE-backed companies with over one million matched firms. The study examined employment changes five years before and after the PE takeover. It found that employment falls more in establishments after a PE takeover than in the control establishments. Employment was about 10% lower five years after the takeover than it would have been without the takeover. Gross job creation was similar between the two types of firm. A follow-up study also found a net employment loss amongst PE-backed firms as well as a relative reduction in wages (which were initially higher in the target firms).

In the UK, Acharya et al (2009) found smaller annual growth in employment in buyouts compared with firms in the same industry. Against this, other studies provide evidence of employment growth after PE takeovers (BCVA, 2006; Harris et al, 2005). Cressy et al (2007) found employment growth in the longer term, possibly because initial restructuring lays the foundation for growth. Studies by Amess and Wright (2007) and Amess et al (2008) found similar positive long-term effects. Other studies by these authors found a difference between management buyouts and management buy-ins, with the former having insignificant effects on employment and the latter more negative effects (Amess and Wright, 2006).

In Sweden, Nyren and Asbrink (2009) compared 50 primary PE buyouts and 22 secondary buyouts, drawn from the population of all buyouts exceeding USD 5 million from 1998 to 2008, with peer groups of the 30 largest Swedish firms in their sector (it is not clear how many firms are entered in total).

They found no significant differences between either type of buyout and their peer group firms in terms of changes in employment or wage levels. Bergström et al (2007) examined the performance of buyouts in Sweden undertaken between 1999 and 2001 and exiting between 2004 and 2006 (n = 73). They found an insignificant impact of PE buyouts on employment and wages. Meanwhile, studies conducted by Nutek and the Swedish Venture Capital Association (SCVA) found that PE companies grow faster than all comparison groups. The study includes a comparison of employment changes between 2001 and 2006, where it was found that median employment growth in PE portfolio companies was 10% (SVCA, 2008). Of the PE companies studied, 66% grew, 26% shrank and the remainder showed no change. This confirmed earlier studies by Nutek (2003, 2004, 2005), also carried out in collaboration with SVCA. While these results are suggestive, the reports point out that the reference groups are not perfect. For instance, they may differ in size, sector and character, and comparisons of PE firms with more carefully defined control groups is deemed necessary.

There are only two survey-based studies in Germany. The first one (carried out by a PE firm in 2004) found that employment growth was on average higher in 70 buyout target companies than in the control sample (4.5% against 2.2% p.a.) (Deutsche Beteiligungs AG/FINANCE, 2004). The second study, sponsored by the German PE Association, showed that median employment growth in target companies excluding turnaround situations was 4.4%; turnaround investments, however, resulted in a median employment decrease of 28.6% (PWC/BVK, 2005).

Studies of Dutch buyouts indicate that employment remained more or less unchanged after buyouts (Bruining et al, 2005).

Many case studies tend to show that restructuring following PE takeovers has led to reductions in employment as well as reductions in wages and benefits, deterioration in working conditions and reductions in employee involvement, voice and representation (Clark, 2009a; Faber, 2006; Kaserer et al, 2007; PSE Group, 2007; SEIU, 2007; Wilke et al, 2009).

It is clear, then, that are sharply diverging assessments of the impact of PE on employment in the academic literature. Much of the debate on the employment effects of PE has revolved around methodological issues. Supporters of PE argue that PE-owned firms reducing employment are often poor performers where employment would have fallen anyway. A problem with case study evidence is that it often focuses on unrepresentative but dramatic cases. However, many of the studies showing beneficial effects of PE on employment suffer from selection and survival biases. Those firms that failed after PE buyouts may not be captured in cross-sectional studies post-buyout. It has been argued, therefore, that many of the results of survey-based approaches should be treated with caution (Vitols, 2007).

There is less evidence on the impact on wages and benefits, though once again there are divergences in findings. Some case studies highlight cuts in benefits in PE-owned companies (Faber, 2006). Thornton (2007) found that in PE-owned firms, pay grows more slowly than in the wider economy. Nevertheless, wages do grow in the period immediately after the buyout (Wright et al, 2007), though average wages tend to be lower in PE-backed firms than others, especially those subject to buy-ins (Amess and Wright, 2007). Evidence from the US indicates reductions in employer health care provision (SEIU, 2007). Pensions are also an area of concern, though there has been little systematic evidence: PE firms may close existing pension schemes to new entrants to reduce employer costs and reduce levels of employer

funding and may sell on pension schemes to secondary operators to shore up balance sheets (Clark, 2009b). However, the impact on pensions is likely to differ considerably between countries because of large variations in national pension regimes and legal systems.

### Work organisation

It is also possible that while some PE-owned firms may reduce employment, they may create better-quality jobs for surviving employees. Unfortunately, there are few studies which test this proposition. The balance of evidence suggests that PE has positive effects on aspects of work organisation. For the UK and the Netherlands, Bacon et al (2004) and Bruining et al (2005) respectively present evidence that PE-backed firms use a variety of high-commitment work practices. After the PE transaction, these firms increase the amount of employee involvement, staff training and flexible work practices. Similarly, for the UK, Amess et al (2007) found that workers in PE-owned firms have more discretion in their work practices than similar workers at non-PE firms. Others, however, have argued that many of these new work practices take the form of 'hard' HR and impose greater pressures on workers (Thornton, 2007).

A 2008 European-wide survey of managers in 190 PE-backed buyouts in 16 countries carried out by CMBOR at Nottingham University provides evidence on the impact of PE on so-called High Performance Work Practices (HPWPs) (Bacon et al, 2010b). This study refers to their findings on the following: work organisation and functional flexibility: flexible job descriptions, team working for majority of staff, regular team briefings, internal promotion norm, required annual formal training and flexible work time; fair practices: harmonised terms and conditions, employment security and formal grievance procedures; pay schemes: payment by results, merit-based pay, profit-related pay and employee share ownership schemes. The study found a positive correlation between increases in HPWPs and anticipated time to exit. Furthermore, buyouts, backed by Anglo–American PE firms (viewed by some as the offenders in this area), were as likely to introduce new HPWPs as those backed by non-Anglo–American PE firms, suggesting some adaptation to local institutional contexts.

### Industrial relations

As with employment, there is divergent evidence on the impact of new investment funds on practices and institutions of employee voice and representation. There are some well-publicised instances where companies have reduced employee voice and no longer bargain with trade unions (Evans and Habbard, 2008; Faber, 2006; ITUC, 2007). Equally, in many instances existing approaches continue with few changes, and the cases of reductions in representation and employee voice may be the exception rather than the rule.

Survey evidence for the UK has shown that 5% of buyouts remove union recognition at the buyout, but the level of union recognition subsequently increases back to pre-buyout levels (Bacon et al, 2004). There are instances where PE funds as well as PE-backed businesses choose to work closely with employee representatives (Beeferman, 2009; Westcott, 2009). In some cases trade unions view PE positively because of its potential to rescue failing firms and because PE may generate good returns to employer-union pension funds (Beeferman, 2009).

The 2008 European-wide survey of managers in 190 PE-backed buyouts in 16 countries cited above provides some more comparative evidence on the impact of PE on trade unions and joint consultative arrangements with employees. Drawing on the survey, Bacon et al (2010a) found that managers reported that PE investment had not resulted in changes in union recognition, membership density or

in management attitudes to union membership. Managers in firms recognising unions after PE buyouts report no reductions in the terms and conditions subject to joint regulation and an increase in the number of consultative committees. Furthermore, they regard these as more influential on their decisions and indicate increased consultation over firm performance and future plans.

This study found that PE acquisition did not result in a perceived decline in consultative committees in any of the national models. They even increased in significance in so-called liberal market economies, such as the UK and Ireland. Managers perceived their consultative committees as more influential in buyouts in liberal market and Central European countries. Consultation significantly increased only in liberal market countries in respect of future plans and employment issues. Social models had a significant effect on consultation before buyout as employee representatives had not been informed about the buyout in the majority of firms in liberal markets. One limitation of the study that should be noted is that, as the researchers point out, questions could not be asked of union or employee representatives; this would be a good area for further research.

### Hedge funds

As yet there are no econometric or large-scale studies of the impact of HFs on employment relations, work relations and industrial relations. The problems facing researchers are that HFs tend to be secretive and possible effects on labour may well be more indirect. Thus, activist HFs may seek to influence company managements through private meetings and pressure, hence this activity is not necessarily readily observable by researchers. It was noted in Section 2 that activist HF objectives tend to focus on shareholder returns and governance reform: while these may have implications for labour and employment, they are not obviously about reforming this area of corporate activity.

The only statistical studies that have been published so far focus on the impact of activist HF investment on company variables such as stock price, performance and profitability (Becht et al, 2010; Boyson and Mooradian, 2007; Brav et al, 2008; Erede, 2008; Greenwood and Schor, 2009; Klein and Zur, 2006, 2009a, 2009b). The results of these studies tend to be polarised between those which stress value creation through HF activism (e.g. through the sale of underperforming operations, governance improvements or the focusing of R&D efforts) and those which find short-term gains (e.g. through increased dividend payouts or reducing investment). The recent study by Becht et al (2010), which covers HF activist events in different European countries, finds that the level of activism varies across countries, with almost half of the activity occurring in the UK, followed by Germany, Italy and France; however, the returns to activism are roughly similar across countries.

There are a modest number of case studies on labour effects of HF activism reported in Wilke et al (2009) and PSE Group (2007). Wilke et al show how in the case of KUKA (a German robotic manufacturer), an activist US HF forced a comparatively fast restructuring process, leading to a massive divestment programme but also to an increase in the profitability of the company. In this case, employment in the firm fell, but this was due mainly to transfer of employees to other owners.

## Sovereign wealth funds

There appears to be even less empirical evidence relating to the effects of SWFs on labour and employment. Given the passive investment strategies generally pursued by SWFs it is likely that the impact on labour has been minimal. Where they have substantial ownership rights, this passivity may well have benefited labour in the sense that company insiders will have had considerable discretion in

the management of the firm. Evidence from elsewhere in the literature suggests insider power will have beneficial effects on employment and wages (Bertrand and Mullanathan, 2001). Again, two case studies by Wilke et al – of the UK company P&O by the Dubai SWF and the French company Cegelec by the Qatari SWF – suggest little consultation with employees or their representatives, but no reduction in employment or conditions greater than the industry average.

However, as noted earlier, the ownership and control strategies of SWFs appear to be changing in the direction of greater activism. As yet, the objectives and effects of this greater activism are not entirely clear, hence it is difficult to isolate any labour or employment effects. Again, this would be a fruitful area for further study.

## The mediating effect of labour and capital regulation

As argued above, labour market and capital market regulation is likely to mediate the effects of new investment funds on employment and labour outcomes. It seems likely that regulation will affect the level of activity of investment funds in countries, the type of firms that they target and the effects of investment funds on labour.

Most studies of investment funds do not engage with the possible mediating effect of regulation. This is because most econometric studies rely primarily on accounting data. Labour and industrial relations features are unobserved. Also, single country-based studies cannot really test the role of regulation because all cases will be subject to the same regulation. However, in principle the role of national regulatory systems can be captured by comparative studies. There is some comparative evidence on the role of labour regulation, but almost none on the role of capital regulation.

Taking the incidence of investment fund activity, the distribution of this across countries appears to correlate with the extent of labour market regulation and employment protection. Those countries with weaker regulation tend to have higher levels of investment fund activity. The UK is a good case in point: the highest level of PE fund activity in Europe coexists with relatively low employment protection and limited information disclosure and consultation. Of course this is certainly not the only explanatory factor. PE fund activity is also influenced by the general growth perspectives in a country, by borrowing opportunities and by regulation of capital markets, to name just a few other factors. Nevertheless, Bozkaya and Kerr (2009) plot PE investments per capita by country against country scores found in the 1998 OECD Employment Protection Index and found that employment protection tends to correlate inversely with PE investments. In the comparative study by Ewald Engelen et al (2008) of investment fund activity in Netherlands and Germany, it was found that the Netherlands has gone much further in the direction of labour market flexibility, such as easier dismissals, casualisation of employment contracts and emphasis on employability. It is notable also that the Netherlands has some of the highest levels of investment fund activity in Europe.

There is little evidence in relation to possible selection effects (i.e. that selection of fund targets may be influenced by the presence and nature of regulation). However, Boucly et al's (2008) study of 830 French leveraged buyouts (LBOs) provides interesting evidence. They found that employment growth is significantly higher in PE firms than in comparable privately owned firms. These firms also show significantly greater growth in profitability. Boucly et al suggest that the presence of a restrictive labour regime means that buyouts tend to be confined to those targets with very good growth prospects. In effect, new investment funds will be reluctant to invest in poorly performing firms because employment protection legislation will restrict the extent to which they can rescue firms through workforce

restructuring. They also argue that weaknesses of the French capital markets, and ensuing credit constraints, mean that PE operates as a source of capital for firms with good growth opportunities.

In terms of the mediating effects of regulation on labour outcomes, the evidence generally supports the view that greater regulation will limit employment changes. Studies by Bruining et al (2005) and Bacon et al (2008) indicate that in the Netherlands, buyouts left most of the employment relations practices of target firms untouched because most are determined at the sectoral or national level. Given the high level of institutionalisation of employment relations in the Netherlands, Dutch buyout firms are 'institutionally captured', as Bruining and Wright describe it, and the room to manoeuvre for new owners is limited. Bruining et al also found that the HR and employment effects of PE are less in the Netherlands than the UK. They attribute this difference to variations in employment protection regimes.

In a similar vein, Lutz and Achleitner (2009) suggest that the institutional context may moderate the effects of PE on employment, based on their meta-finding that studies of employment change in France, Spain and Belgium (all relatively highly regulated countries) indicate positive effects. They contrast stakeholder approaches to governance in mainland Europe with shareholder value-oriented economies such as the US and UK. Differences in labour regulation are likely to play a part here. They also note that where capital and buyout markets are less well developed, PE may complement these markets by providing capital to firms that would otherwise be capital constrained. By contrast, where markets are well developed, PE firms may invest more in firms that offer opportunities for efficiency improvement rather than growth opportunities (Lutz and Achleitner, 2009: 12).

Finally, information disclosure, consultation and co-determination are likely to affect the extent to which employees and their representatives can contest initiatives by investment funds which potentially impact on labour and employment. The case studies of funds reported in Wilke et al (2009) show how well-developed information and consultation institutions and co-determination rights can modify and mitigate restructuring attempts that are likely to impact negatively on employment and jobs.

A recent study of the effects of PE by Bacon et al (2010a) compared employee relations changes under different social models in Europe, distinguishing between Northern Europe (Denmark, Finland, Norway and Sweden), Mediterranean Europe (France, Greece, Italy, Portugal and Spain), liberal markets (Ireland and the UK) and Central Europe (Austria, Belgium, Germany, the Netherlands and Switzerland). The results suggest that PE firms adapt to national systems and that national institutional differences persist after buyout, since PE investors and managers are not able to avoid union representatives as important channels of communication in unionised firms.

Regarding the regulation of capital, there is a surprising lack of literature on the role of capital market variables in mediating the impact of HF, PE and SWF investment on employment and labour outcomes at the micro level. However, the literature does address the impact of these variables on other outcomes which have relevance for employment – such as innovation potential and economic growth. Some of this literature is comparative and attempts to explain variation across countries, e.g. different levels of activity (Becht et al, 2010; Bozkaya and Kerr, 2009; Engelhardt, 2007).[11]

[11] In the area of shareholder rights a set of articles produced by the Law and Finance group around La Porta et al argue that weak minority shareholder rights discourage investment, leading to less economic growth. This is based on surveys of shareholder rights and econometric analysis at the country level.

# The country cases 4

This section analyses the activities of all three fund types in seven countries, looking at the framework of national legal regulations and industrial relations in each case. The same outline has been used for all seven country reports. However, there are differences not only in the activities of funds but also in the quality of information available. The country analyses are organised in the following way: first the institutional and mediating context is described with regard to capital regulation and labour regulation. Then a summary is given of the activities of funds. Third, the outcomes of fund activities on company level are considered by using material from the company case studies. Finally, an overview is presented on the positions of social partners and the impact of the recent financial crisis before country-based conclusions are drawn.

## United Kingdom

The UK is often seen as one of the prime liberal market economies. It is a country where external finance via the stock market and outsider corporate governance via M&As and the threat of hostile takeovers are important. Big firms have tended to dominate the UK economy more than in most other countries and ownership in such firms is dispersed. In particular, there is extensive ownership of large firms by British and foreign institutions (insurance companies, pension funds and mutual funds). Relative to many other countries, it has been possible to buy shares in UK companies and to acquire companies outright. In other words, there is an active market in corporate control. In this context, PE and HF activity is the highest in Europe. To date, SWF activity has remained modest, though there are no legal constraints on SWF acquisitions and again the UK is a very open market and has been an important target for such investment.

Employees in UK companies enjoy rights to information and consultation, but there are no legally based works councils and no board-level employee representation, as in Germany and some other European countries. Employment protection in terms of collective dismissals and transfers is middling by European standards, with much law having been derived from EU directives. Arguably, for employee voice to have effective meaning in the UK, it has to be backed up by trade unions. However, in the past 30 years union membership and influence have decreased. Nevertheless, the activities of PE and HFs have been controversial among trade unions and some politicians, and this has come to constitute a public image constraint on their activity.

### The institutional/mediating context

As suggested above, the UK has traditionally been said to have a market-based financial and outsider-orientated corporate governance system in which worker representatives have relatively weak formal rights under the law and weak implicit contracts with management relative to some other major European countries. In recent years, notions of shareholder value have influenced both legal developments and management behaviour (particularly in larger companies).

*Capital regulation*

1) ***Regulation of investment funds***. The UK has an extensive body of company and other securities, banking and insolvency law. There is no law specifically on PE and HFs. Such funds are in effect subject to general aspects of company, securities and competition law. PE funds have fewer obligations to disclose than other types of investment funds. In essence, they are treated as collections of private investors, and as they do not usually seek retail market funds, they are not covered by regulations governing the sale of investment products. As private entities, PE-owned businesses are generally exempt from the disclosure and corporate governance requirements faced by stock market-listed firms.

The fund managers of HFs operating in the UK are required to register with the Financial Services Authority (FSA) and to be approved as fit and proper to conduct investment business. Authorised HFs are bound by the FSA's codes of market conduct. HFs also have to obey basic UK commercial and securities law, but are not especially regulated. Partly as a result of this light regulatory regime, the UK has a relatively large number of HFs and such funds operate widely.

Similarly, in the area of M&A, there are also significant elements of self-regulation via the City Takeover Panel, which applies extensive but, relative to other countries, permissive rules to takeover situations. In recent years, however, in part responding to EU initiatives, this has come to be more legally based. Despite this, the UK is still a relatively open country for M&As, including hostile takeover bids.

Since 2002 the power of UK government ministers to intervene in takeovers has been eliminated, except in very exceptional circumstances (where there are national security issues or where press plurality is threatened), and there are no generalised public interest criteria to be considered when M&As are mounted. Instead, the Office of Fair Trading can refer cases to the Competition Commission, where there is likely to be a substantial lessening of competition. Previously, ministers could refer cases to the Competition Commission on grounds of promoting the balanced distribution of industry and employment in the UK. From 1990, the government noted that it would 'pay particularly close attention to the degree of state control of the acquiring company'. Interestingly, one of the case studies in this report, Dubai Port World's (DPW) takeover of P&O, might have fallen foul of this provision.

2) ***Shareholder rights and duties***. In the area of shareholder rights and duties, the UK has long been thought to have relatively strong minority shareholder rights protection, with 'one share one vote' and without special voting rights As a result, the UK receives high marks on indices such as the Shareholder Rights and Duties Index (Djankov et al, 2006).

3) ***Tax law***. The tax treatment of PE has received particular attention in the UK. Two aspects of taxation are relevant: first is the capital gains tax (CGT) regime as it applies to PE general partners' returns, and the second is the corporation tax treatment of debt.

First, because general partners themselves invest in the fund (typically 1% to 3% of the fund's value), their return (carried interest) is viewed as a capital gain on a business asset. This has been controversial because it can be viewed as a return for services and thus might be subject to income tax. Until 2008, the CGT treatment was very generous, with the tax liability tapering to 10% after two years, as compared with the marginal income tax rate for high earners of 40%. Following a public outcry over the tax treatment of PE, the government abolished business assets taper relief in 2008 and replaced it with a flat CGT rate of 18% (now 28% for higher-income taxpayers).

The second area of controversy is that interest payments on debt used by PE funds to acquire companies can be set against corporation tax given that the debt is typically loaded onto the balance sheet of the acquired companies. It has been suggested that this practice may have an adverse effect on UK tax revenues. It has also been suggested that the tax system may favour debt over equity, especially after the removal of dividend tax credits in 1997, and that this may have a distorting effect. However, one limitation of UK tax law from a PE perspective is that the most recent all-employee share ownership plan – the Share Incentive Plan – cannot attract tax benefits for employees when the employing company is under the control of another (i.e. PE fund).

Investments in offshore entities (and HFs are often registered offshore) qualify for CGT treatment as long as certain reporting requirements are met.

Overall, the EVCA benchmarking report for 2008 gives the UK a good score relative to other European economies for the legal and tax environment.

4) ***Constraints on foreign investment***. There is no special UK law regulating foreign investments, such as those in the US and Germany. Hence, for example, one of the case studies in this report (the acquisition of P&O by DPW) may well not have taken place in many jurisdictions. Indeed, the US ports owned by the company were taken out of the deal at the insistence of the US Congress. This was not the case in the UK, in what some would see as an area of national interest. However, in some even more sensitive areas relating to arms production and gas and oil, it would seem likely that any UK government would intervene to restrict major investment or takeover by certain foreign funds. How the law would see this is unclear.

*Labour regulation*

1) ***Employment protection***. The UK scores below the OECD average with regard to overall employment protection and the important case of collective dismissal protection.

On transfer of undertakings, it is important to note that PE takeovers, as share transactions, are not viewed as a change of control which triggers employee rights to information and employment protection under the EU Directive on Safeguarding Employee Rights in the Event of Transfer of Undertakings (TUPE).[12] When shares are sold and the ownership of the company transfers to new owners, this has no impact on the contractual relationship between the employee and the company being sold: the legal relationship remains unchanged and is identical before and after a sale. If a purchaser subsequently wishes to change any employment conditions, they must do so in exactly the same way as if no sale had occurred. If the assets or the business undertaking are sold rather than shares, the employees will have a new contractual relationship with the acquiring company. They will cease to be employed by their former employer and become employees of the company that bought the assets or undertaking.

2) ***Information rights***. UK employees have rights to information and consultation in various situations, the most relevant here being collective redundancies and M&As. This is not through any specially created legal channel, such as a works council, though these may be established under UK law derived from the EU Information and Consultation Directive. It should be noted that these have not been much used. Trade unions also have certain rights to information and consultation in collective bargaining situations. Again, however, this law has not been much used and is considered by the unions to be weak and ineffective. It should again be noted here that there is no legislation on board-level representation in the UK.

3) ***Decision-making and the role of trade unions***. There are no special decision-making rights for employees in the UK, such as exist in Germany, the Netherlands and Sweden. Much therefore depends on what trade unions can obtain for their members. However, in the private sector, union membership has fallen to below 20%, the areas covered by collective bargaining have become limited and bargaining seldom takes place at company level, where it matters most for corporate governance. It is perhaps

[12] 2001/23/EC. This replaces Directives 77/187/EC (the Acquired Rights Directive) and 98/50/EC.

significant that in the UK unions have had to resort to public relations campaigns, as detailed in the Automobile Assocation (AA) case study in this report.

### Funds

Both PE and HFs are well established in the UK. According to the definition used in this study, the UK itself has no SWF, but British companies have been the target of foreign SWF interventions.

*Private equity*

The UK has the largest PE sector after the US, and six of the largest PE funds by capital raised are based in the UK (CVC Capital Partners, Permira, Apax Partners, Warburg Pincus, 3i and Terra Firma). Between 2003 and 2008 these funds raised approximately USD 150 billion.

Even in the very depressed market conditions of 2009, PE investments accounted for 0.41% of GDP. In recent years PE buyouts have accounted for about 20% of all M&A deals in the UK. Their proportion of the value of M&A has risen steadily, reaching a peak of around 60% in 2007 (CMBOR). The scale of PE deals has risen during the 2000s, culminating in the acquisition of a FTSE 100 company (Boots) by the US fund KKR in 2007. Around 1,300 UK businesses received PE funding each year. The BVCA has estimated that PE funding accounts for the employment of around three million people in the UK (approximately 21% of private sector employees) (BVCA, 2006).

Following extensive public and political criticism of PE funds in 2007, a set of voluntary guidelines was accepted by the PE industry (the so-called Walker Code).[13] These guidelines require that a portfolio company should publish its annual report and accounts on its website within six months, including information on the identity of the PE fund owners and managers, and provide an annual business and financial review similar to those provided by listed companies. PE funds should publish information on their structure, investment approach and UK investee companies, along with summary information on the investor base. Information should also be provided regularly to the trade association, the BVCA, which should monitor the operation of the guidelines. The guidelines recommend that a PE firm should ensure ‘timely and effective communication with employees, either directly or through its portfolio company, as soon as confidentiality constraints are no longer applicable’, especially at times of ‘strategic change’. Although these requirements are not legally binding, in April 2009 the Guidelines Monitoring Group reported that all 32 PE firms covered had fully complied with the guidelines (walker-gmg.co.uk).

*Hedge funds*

The UK has the largest concentration of HF managers outside the US, with around 20% of global HF assets managed by London-based fund managers. Approximately 80% of European HF investments are managed from London. At the end of 2008 there were just over 800 HFs operating out of London, with around USD 300 billion of assets under management. Five of the largest HFs by assets are UK-based (Brevan Howard Asset Management, Man Investments, Barclays Global Investors, BlueBay Asset Management and Bluecrest Capital Management). About 40,000 people are directly employed in the HF industry in the UK. However, it should be noted that funds themselves are typically registered offshore for tax treatment (usually the British Virgin or the Cayman Islands).

[13] These apply to both PE funds and their portfolio companies, where the latter were acquired in a public-to-private transaction exceeding GBP 300 million and more than 50% of revenues are generated in the UK and there are more than 1,000 full-time employees, or in a secondary transaction in excess of GBP 500 million and 50% of revenues come from the UK and where there are more than 1,000 employees.

Most HFs have small positions in investee companies: examples of larger investments in 2008/2009 include RIT Capital Partners' holding of 17.4% of the equity of PayPoint and Waverton Asia Pacific's holding of 1.3% of Prosperity Mineral Holdings Ltd. Most HFs operate directional strategies. Around 10% operate event-driven strategies, attempting to take advantage of special situations, such as M&As or divestitures. Around 15% operate a mixture of investment approaches.

Activist and event-driven HFs appear to be growing in importance in the management and governance of UK companies. A prime example is the intervention of US HFs in one of the case studies in the attachment to this report, the UK confectioner Cadbury; this encouraged significant changes of strategy by this company and ultimately led to its takeover by US food company Kraft in 2009.

*Sovereign wealth funds*

Unlike some European countries such as Norway and, recently, France, the UK does not operate a SWF. However, the UK is an important centre for SWF operations, with most of the major SWFs operating a London office. The UK is also an important target of SWF funds, accounting for 49% of such funds invested in Europe over the period 1995–2009. For its part, the UK government has actively welcomed SWF investment and management activity in the UK.

Most SWFs hold relatively small stakes in UK companies (1% to 3%), but there are examples of larger stakes. For example, in 2008/2009, the Qatar Investment Authority had a 27% stake in the supermarket company J. Sainsbury and there has been persistent speculation that this SWF will mount a formal takeover bid. Qatar also held a 15% stake in the London Stock Exchange in 2008/2009. A Singaporean SWF, Temasek, holds an 18.8% stake in Standard Chartered, a UK banking and finance group.

It seems likely that the absence of a public interest criterion in UK takeovers facilitates and encourages SWF investments in the UK.

*Overall assessment of relative importance*

Despite setbacks during the dotcom crash and the current financial crisis, PE has grown in importance in the UK since the 1980s. There have been a number of peaks of activity: the late 1980s, the late 1990s and the late 2000s prior to the beginning of the credit crunch in the summer of 2007. The value of PE buyouts has risen steadily during the period, with particularly marked growth in the mid-2000s. The number of very large PE buyouts rose in the 2000s (e.g. Boots, the largest in Europe, and EMI), but these are still relatively few in number. It is difficult to compare this with HF and SWF activity, but both appear to have grown over the long term.

### Outcomes and effects on companies

The debate on the effects of PE and HFs in the UK has been highly polarised (to date, however, SWFs have played less of a role, in large part due to their lower level of activity). On the one hand, parts of the financial and academic community have argued that the UK needs more activity from these types of funds. Buyout capital is needed to help deal with the restructuring of companies. Some observers have argued that PE and activist HFs can help change corporate governance in a more value-maximising direction. On the other hand, trade unions and others have criticised PE and HFs on the grounds that they maximise returns to their funds at the expense of employees and other stakeholders. In terms of effects on employment, work and industrial relations, trade union-oriented research argues that both PE and HF investments disregard employee rights of information and consultation and have

negative effects on employment and working conditions. By contrast, the BVCA argues that in the long term employment has grown under PE acquisitions and in the majority of cases industrial relations are conducted amicably with employees.

Despite the importance of AIFs in the UK, there have been few academic studies of their impact. Part of the problem has been that information and data have not been readily forthcoming from the firms themselves. However, as listed below, there have been a number of studies of PE ownership of portfolio companies (Gilligan and Wright, 2010). Case studies and econometric studies are surveyed below. To date, the UK has a good number of studies of PE, but there is very little research into HFs and SWFs.

*Case studies*

In the past few years there have been a number of case studies of PE and HF involvement in UK companies. The PE case studies include a wide variance in employment and industrial relations outcomes. In many cases, PE firms and the new management they install have continued the prevailing approaches to work and employment. In other cases, an adversarial situation has arisen and trade unions complain that they have not been informed about the acquisition and about subsequent restructuring plans which have led to a deterioration in conditions. After the high-profile privatisation involving the PE-backed management employee buyout of the transport group NFC in 1982, the best-known recent case is that of the AA, acquired by PE in 2004. Shortly after acquisition, the company derecognised the GMB union, made a significant number of redundancies and substantially changed working patterns. However, the extent to which these developments can be blamed on PE is open to doubt, since it is difficult to judge what the counterfactual situation would have been. Following the initial restructuring, the company recorded an increase in employment.[14]

Anecdotal information on HF interventions suggests that there is rarely direct contact between worker representatives and HFs and that the activist plans of HFs do not intervene deeply into employment conditions, work organisation and industrial relations. However, the Cadbury case study in the attachment to this report shows how a major UK company was very much shaped by HF interventions. In this case, these were associated with changes of strategy and divestments in that company, and these in turn had some adverse effects on employment. The subsequent sale of the company to Kraft may have resulted from the initial HF interventions and was certainly affected by HF interventions during the actual takeover process. Nevertheless, it is difficult to isolate precisely the effects on employment and jobs in that company.

To date, there appears to have been only one case study of SWF activity in the UK (Wilke et al, 2009).[15]

*Statistical/econometric studies*

There are several econometric studies of PE portfolio firms in the UK, mainly conducted under the aegis of the CMBOR at Nottingham University (see Gilligan and Wright, 2010 and Wright et al, 2009 for an overview). For the most part they use material collected in confidence from the PE sector as well

[14] See the UK case study in the attachment to this report for more details of the AA case. I. Clark (2009), ‘Private equity and union “recognition” at the AA’, mimeo University of Birmingham, provides the story from the GMB perspective. The authors would like to thank Ian Clark for discussions about this case and also Mike Wright, University of Nottingham, for providing other information and also for discussions. See also Work Foundation, *Inside the dark box: Shedding light on private equity*, London, WF, 2007.

[15] See the DPW and P&O case in the attachment to this report for the dynamics and outcomes of this case.

as portfolio companies' annual published accounts and incorporate the several waves of PE-backed buyouts since the early 1980s. To date there do not appear to have been any UK econometric studies of the labour effects of HFs and SWFs.

Amess et al (2008) compare the employment effects of leveraged buyouts (LBOs) and traditional acquisitions against a large control group. They found a 4.5% fall in employment in the immediate aftermath of the transaction, but insignificant effects in the longer run. By contrast, traditional acquisitions significantly reduce employment compared with the control group for up to three years post-transaction. They break down the LBO group into those backed and those not backed by PE. The PE-backed group had no significant employment changes relative to the control group, but the non-PE backed group showed significant falls. Cressy et al (2007) compare 48 UK PE-backed buyouts with a matched sample of 84 companies over a five-year period and found that employment falls in the PE sample over four years. However, they found that job cuts are associated with higher operating profits, which in turn contribute to job creation. Amess and Wright (2007) compare the employment effects of management buyouts (MBOs) and management buy-ins (MBIs) (PE is more usually associated with the latter) and found that MBIs have a small negative impact on employment, whereas MBOs have a positive effect. They found that wage growth is slower in both MBOs and MBIs than in comparable firms.

A survey of buyouts and buy-ins in the UK and Netherlands finds that employee involvement, job flexibility and training all increase after the buyout (Bacon et al, 2008). However, it has been shown that PE-backed buyouts are less likely to use high-commitment work practices than buyouts which are not backed by PE. Amess et al (2007) found that employees in buyout firms have more discretion over their work practices than comparable workers at non-buyout firms. Meuleman et al (2009) show that UK buyouts backed by more experienced PE firms and buyouts of divisions have higher growth in employment than other types of PE-backed buyout, while Weir et al (2008) show that public-to-private buyouts tend to experience employment declines.

There are fewer studies dealing with effects on industrial relations. However, regarding union recognition, one study suggests that 5% of buyouts remove union recognition at the buyout but the level of union recognition subsequently increases back to pre-buyout levels (Bacon et al, 2004).

**Views of the social partners**

The main British business organisation, the Confederation of British Industry (CBI), has a generally positive view of PE and other investment funds, arguing that they are a successful part of the British economy. However, it has argued that external communications have been less successful, with PE failing to convince others of its success, especially in the 2000s wave of buyouts. For this reason the CBI welcomed the Walker Review and greater voluntary transparency. It argues that promotion of such best practice is preferable to a rules-based system. The CBI has also accepted the view of the Walker Review that the remuneration of fund general partners does not need to be made public. It has argued that the voluntary principles accepted by the PE industry should also be accepted by other investment funds such as SWFs.

The CBI has been highly critical of the proposed AIFM Directive on the grounds that it would impose onerous constraints on PE and HFs. Since the UK has the largest alternative investment sector in the EU, it is argued that the Directive would hit UK financial services especially hard (as well as EU financial services more generally). It would also restrict the ability of funds located outside the EU to

operate within the EU. It argues that the Directive would create an uneven playing field, with fund managers within banks having greater latitude than standalone PE and HFs. The Directive would require greater disclosure of PE-owned companies than other forms of ownership, and this disclosure would be more extensive than in current industry best practice, thereby putting PE at a competitive disadvantage. Other criticisms include the following: proposed annual independent valuations of fund assets are unnecessary given annual audit under companies' legislation, and restrictions on leverage create an uneven playing field with respect to other forms of corporate ownership.

The CBI has had much less to say about HFs and SWFs than about PE.

The trade union confederation in the UK, the Trades Union Congress (TUC), has been critical of PE and HFs though there has been recognition that companies taken over by PE may prosper. Three main areas of concern have been identified, especially in relation to PE: lack of responsibility of funds to employees and the community; lack of transparency, especially in relation to the rewards available to PE general partners; and the sustainability of the business model given the reliance on debt. More broadly, the TUC has expressed concern that PE and HFs pose challenges to the stability of the international financial system. It has suggested that the OECD and G8 should establish a taskforce to develop appropriate regulation and taxation arrangements on an international level.

While union concerns have often focused on the fate of employees in firms taken over by PE and HFs, there is also the issue of union involvement in pension fund management. There has been increasing investment by pension funds in PE and HFs as a way of enhancing returns. The TUC has produced a guide for union trustees of pension funds, pointing out the possible dangers of investing in these asset classes. These include the illiquidity of investments, the level of risk, the sustainability of debt-based business models, short-termism and conflicts of interest faced by company directors involved in mounting buyouts (TUC, 2007).

In the wake of the recent sale of Cadbury to Kraft (which, as the case study shows, was expedited by the involvement of HFs), the TUC has called for the creation of an independent M&A commission and for the introduction of an economic test for whether M&As should be allowed to proceed. This economic test would take into account whether the takeover would be beneficial for the target company and also in the interests of employees, local communities, suppliers and the wider economy. It has also called for TUPE protections for employees to be extended to takeovers that take place by share transfer (as is usually the case in PE deals).

Large member unions of the TUC, such as UNITE and the GMB, have been highly critical of PE and have undertaken a number of actions in response to the increased activity by PE and HFs. Through campaigns they have increased public awareness about specific cases and made demands on the government for legislative changes. As Clark (2009a) has outlined, these unions have been critical of PE in four main respects: employee protection when businesses are transferred; disclosure and transparency; the threat to pensions where pension assets are used as collateral for leverage; and implications for tax income and social welfare. The GMB, for instance, has campaigned for interest payments on debt to be made taxable. These campaigns have enjoyed a degree of success insofar as the PE industry has come to accept a greater degree of voluntary disclosure and, as outlined above, the Labour government changed the basis of CGT in 2008. Before its demise, the Labour government also undertook to consider revisions to TUPE and information consultation rights.

However, British unions have probably not been as successful in organising networks of union representatives, as is the case with German works councillors. Nor do there seem to be cases where unions have developed relationships with specific PE firms and helped establish 'beauty contests' between competing PE firms to see which one offers the best deal for employees at the target firm, as has occurred in the US.

There is little information on the attitudes of British unions to HFs and SWFs. All that can be said is that they are largely suspicious of the former, not least after the Cadbury case, and rather less unfavourably inclined towards the latter.

### The present financial and economic crisis

The number of PE deals in the UK has fallen significantly since the beginning of the credit crisis in 2007. The value of buyouts has dropped dramatically, from GBP 68 billion in 2007 to GBP 6.3 billion in 2009 (CMBOR). In 2009, there were only 19 buyouts valued between GBP 50 million and GBP 500 million. Public-to-private buyouts fell to 15, while secondary buyouts fell to 27. However, the first quarter of 2010 saw signs of a recovery in the UK PE market (CMBOR, 2010).

A major area of difficulty for PE funds has been exit. The opportunities for successful initial public offerings (IPOs) have been considerably reduced, despite the growth in asset values during 2009, and several major IPOs have been postponed in 2010. Similarly, the opportunities for selling firms to other PE houses have also been reduced, although the first quarter of 2010 saw a marked increase in secondary buyouts (CMBOR, 2010). Faced with these difficulties, and with a decline in returns, some PE firms have experienced pressures from investors for withdrawal of their funds.

Overall, the credit crisis has posed great difficulties for the PE business model. As it is reliant on high levels of leverage in most cases, restrictions on the supply of credit have inhibited refinancing deals, leading to costly increases in debt. In turn, this has added to the difficulties in exiting investments. On the other hand, the crisis has created new opportunities for PE funds focusing on turnaround situations. The crisis has likewise created opportunities for some HFs. This has been particularly the case for those specialising in purchasing distressed debt. However, the recent decline in the number of M&As has limited the potential for those HFs focusing on special events.

Some SWFs were initially hurt by the crisis in the financial services sector and have been more reluctant to invest in some Western companies, including those in the UK. Some of them may also have fewer funds in the future to invest in Western companies. However, it is also possible that relative to other sources of funds, their importance may grow. It is perhaps significant that during the BP crisis in 2010, the firm considered turning to Gulf State SWFs for fund. The case of the Dubai funds has also raised another spectre: that some SWFs may have overreached themselves in terms of involvement and acquisition and this may have future restructuring implications.

### Conclusions

The UK represents a case in which a broad variety of employment outcomes have resulted from PE, HF and (to a lesser extent) SWF investment. These have been mediated by both the strategies of the funds and the regulatory context in which they operate. The UK has represented an important area of activity for PE investors, as shown by the large number of funds and the extent of their activity. This can be explained by several factors: the openness of the City of London and its interconnections with New York; the demand for PE due to corporate restructuring and opportunities for activist HFs; a friendly legal and tax framework; and the relative weakness of industrial relations-type constraints. SWFs have also found the UK fertile ground because of the openness of the British economy.

In terms of outcomes, it would seem that fund involvement does not mean either an automatic win-win situation for both sides or an inevitable zero-sum situation where workers are negatively affected. Rather, outcomes appear to be dependent on factors such as the type of fund and its strategy, its willingness to work with employees and the possibility of adverse public scrutiny and criticism. Overall, PE has had more effect than HFs, except in certain key situations. HFs can have a significant effect on the fate of a company and have major employment implications. SWFs have had the least effect.

## Germany

Germany is generally seen as one of the strongest so-called stakeholder economies in Europe and one of the leading examples of a bank-based (as opposed to stock market-based) system of finance and corporate governance. Compared with the UK and the US, a relatively small number of companies are listed on the stock market. Until the late 1990s, many listed companies were protected from takeovers by concentrated ownership structures, extensive cross-ownership involving German banks and insurance companies and special voting rights for 'inside' owners. In labour relations, worker representatives enjoy specific rights to information, consultation and co-determination through works councils and, in larger companies, board-level employee representation (BLER). Employment protection is relatively strong in comparison with other European countries. However, the situation has changed somewhat over the last decade due to the internationalisation of some of the larger banks and a number of important reforms in the financial system and corporate governance. In these circumstances, PE and HF activity has increased significantly. These funds have been highly controversial, with trade unions and some leftist politicians taking a critical stance in the media. To date, SWF activities have remained modest, but the case studies in the attachment to this report suggest some potentially important developments in terms of the stakes taken by such funds in some German manufacturing companies.

### The institutional/mediating context

The German industrial system is often portrayed as a stakeholder system in which worker representatives have comparatively strong rights and an implicit contract with management exists in which long-term tenure is exchanged for workers' willingness to invest in firm-specific skills. On the one hand, management and owners are expected to have a long-term orientation whereby they will accept temporary financial losses in order to maintain employment. On the other hand, trade unions are expected to make compromises in times of crisis and not to exercise their full market power during upturns. However, in recent decades this relationship has changed somewhat as shareholder value notions have come to influence both legislation and management behaviour, particularly in larger listed companies.

*Capital regulation – a changing environment*

Growing competition in international financial markets and the integration of Germany into the EU have led to several major reforms to the German regulatory framework. These have important implications for the operation of investment funds such as PE and HFs.

1) ***Regulation of investment funds***. Starting in 1990, Germany has passed four different Financial Market Promotion Laws (*Finanzmarktförderungsgesetze*) designed to bring the country's financial system more in line with structures and practices found in the US and UK. Each of these laws has included a package of measures to reform securities, banking and company law.

A related aim has been to create a more friendly environment for investment funds, including PE funds and, to a certain extent, HFs. The second of these acts authorised the operation of investment companies

(from 1998) and established a framework for their registration and regulation, including transparency requirements. This legislation was also designed to improve the attractiveness of the Frankfurt financial market and the competitive position of German banks.

However, although the EVCA 2008 benchmarking report gives Germany high marks in some areas (specifically in the freedom of insurance companies to invest in PE and in the availability of a 'PE-friendly' fund structure – the GmbH & Co KG), in other respects EVCA sees Germany as being significantly below the European average. High levels of taxation are a key factor in this respect (see below).

A further aspect of the Financial Market Promotion legislation was the creation of a Securities Market Regulator in 1994, broadly similar to the US Securities and Exchange Commission (SEC). In 2002 this regulator was merged with the banking and the insurance regulatory agencies to create a unified financial system regulator, BaFin. This is responsible for regulating investment funds in Germany.

A further part of this effort was to authorise the establishment of HFs in Germany from 2004. However, the regulations covering HFs are quite strict in comparison with other countries. For example, in the interests of diversification, only funds of funds (and not single HFs) can be publicly marketed. Directors of HFs also have to register with the regulatory authority and prove that they have the necessary experience. As a result, relatively few HFs have been established in Germany. Thus, the activities of HFs in Germany are essentially investments of foreign funds in German companies.

2) ***Shareholder rights and duties***. Germany has made important changes to strengthen minority shareholder rights. Specifically, Germany is now a leading exemplar of the 'one share one vote' principle, due to the elimination of multiple voting rights, voting caps and other measures which privileged inside investors. Even so, Germany only receives moderate marks on indexes such as the Shareholder Rights and Duties Index. This means that Germany is somewhat of an average case regarding the ease with which activist investment funds can pressure company management to make changes.

3) ***Tax law***. The EVCA benchmarking report is rather critical of Germany on the grounds that various provisions of German tax law are significantly below the European average in terms of favourability to investors. The corporate tax rate, top personal tax rate and taxation of stock options are all above the European average. There are less pure fiscal R&D incentives for companies and net interest payments on debt are only partially deductable. The tax rate for carried interest is roughly in line with the European average. Only the taxation of performance-based incentives is more favourable than the European average. According to EVCA, this means that Germany is somewhat less attractive than most European countries as a location for PE investment.

4) ***Constraints on foreign investment***. The law regulating foreign trade (*Aussenwirtschaftsgesetz*) was recently modified. As of 2009, the Economics Ministry has the right to vet foreign investors, such as SWFs, which seek to acquire more than 25% of the equity of a German company. The ministry has the right to veto these investments in limited circumstances, e.g. in arms production. To date, the practical relevance of the law has been limited. There have been several long-term investments by Middle Eastern SWFs in large German companies (for example in Thyssen Krupp AG, Daimler AG, Volkswagen AG and others) since the 1970s. Even the announcement of a major investment by the Abu Dhabi MAR in Thyssen Krupp Marine Systems, including a share of 50% in a partnership for naval ship construction, has not led to criticism in Germany.

*Labour regulation*
The German economy is said to be characterised by labour market inflexibility arising from a high level of labour regulation and the strong position of the German trade unions. This means that it might be relatively difficult for investment funds to make changes in a company or to reduce its workforce.

1) ***Employment protection***. Germany scores above the OECD average with regard to overall employment protection. In the case of collective dismissals, protection is particularly strong compared to the OECD average. The definition of collective dismissal is among the strictest in the OECD. The procedure to reduce the workforce through collective dismissals takes a long time. As a result, dismissals are typically costly. However, employment protection for temporary workers is considerably weaker and individual dismissal protection is in line with the European average.

2) ***Information and consultation rights***. Most workers in Germany enjoy well-established information rights, conditional on the size and legal form of the firm. The main channel of information for most workers is through the works council. In principle, a works council can be elected in any plant with five or more regular workers, as defined by the Works Constitution Act. In most companies in the core industrial sectors with more than 100 employees there will be a works council. However, due to a relatively low rate of organisation in smaller plants, only about half of all workers are actually represented by this mechanism. Works councils enjoy extensive rights to information on financial and employment-related matters. In companies with more than 100 employees, an economic council (*Wirtschaftsausschuss*) should also be established specifically to receive financial information. In companies with more than 500 domestic employees, one-third of supervisory board members are employee representatives; in companies with more than 2,000 domestic employees, half of the supervisory board members are employee representatives. However, in certain types of company (e.g. media companies), there are no economic councils and/or board-level employee representatives. Roughly one-quarter of workers in Germany are employed at companies with board-level employee representation. Board-level representation is also an important source of information for worker representatives.

3) ***Decision-making rights***. In addition to information and consultation rights, works councils and board-level representatives also enjoy decision-making rights in the company. Works councils have negotiation rights over important employment-related matters, such as job definition, pay system determination, introduction of new technologies, approval of overtime or short-time work and the negotiation of social plans in the case of mass redundancies. Board-level employee representatives have the same rights as other supervisory board members, i.e. to ask management questions, participate in discussions, be members of board committees and vote on strategic matters.

An important implication for restructuring is the fact that agreements between works councils and management continue to apply even when a plant has been sold. In larger companies, works councils are often involved in the process of selling a plant or division. For instance, they may seek to identify potential purchasers who are acceptable to the works council.

4) ***Trade unions and collective bargaining***. Germany has a relatively unified labour movement, with over four-fifths of union members belonging to one of the affiliates of the German trade union confederation, the Deutsche Gewerkshaftsbund (DGB). A series of mergers in the last two decades has reduced the number of affiliates, and about 70% of affiliated members belong to either the metalworkers' union, IG Metall, or to the public and private services union, Ver.di. Multi-employer bargaining is the

norm in Germany, although some employers have company collective bargaining agreements with a union (e.g. Volkswagen). Union density has decreased over the past few decades to less than one-quarter. However, since collective agreements apply to companies with a low union membership rate, about two-thirds of the workforce is covered by binding agreements or by the informal application of an agreement by an employer.

Trade unions negotiate over a wide variety of wage and working condition issues. According to labour law, there is a strict division of labour between issues negotiated with works councils (at plant or company level) and with trade unions. However, trade unions have managed to attain a strong degree of influence within companies by running slates of candidates for works council elections. Trade unions also nominate board-level candidates for company boards.

**Funds**

There are differences in the economic importance, organisational structure and visibility between PE, HFs and SWFs in Germany. There is an established PE community. German HFs, however, are almost nonexistent, though foreign funds are quite active. According to the definition used in this study, Germany does not have an SWF of its own, though again foreign funds operate.[16]

*Private equity*

The PE community in Germany, represented by the BVK (German Private Equity and Venture Capital Association), is rather diverse, composed of three distinct types of investment funds with different interests and traditions. First, SME funds (often state-owned) invest patient capital in traditional SMEs. Second, venture capital (VC) funds invest mainly in start-ups. Third, buyout firms invest in established companies. In all, 212 funds are members of the BVK and it is estimated that another 30 funds are active in Germany but are not members of the BVK. Most of the larger members are subsidiaries of US- or UK-based PE funds such as Carlyle and Permira. Fundraising by German funds amounted to just over 10% of the volume of fundraising by UK-based firms in 2007 and a little more than 5% of the UK volume in 2008.

| | | 2007 |
|---|---|---|
| All portfolio companies in Germany (approx. 6,200): | Sales (€ million) | 194,800 |
| | Employees | 1,083,300 |
| Number of companies in Germany funded in the course of the year (approx. 1,000): | Sales (€ million) | 28,900 |
| | Employees | 216,500 |

**Table 6 Sales and employment at PE-funded companies in Germany**

Source: *BVK statistics, 2007*

However, in 2007 Germany was the third largest market in Europe for inward investment in absolute terms after the UK and France.

[16] There is some state ownership of companies, but this tends to operate through state-owned banks (e.g. Kreditanstalt für Wiederaufbau) or regional banks (Landesbanken) and this is restricted to companies in Germany.

*Hedge funds*

There are very few HFs headquartered in Germany. As of March 2010, there were only 15 single HFs and eight fund-of-funds registered with the regulatory authority (BaFin). A somewhat broader definition offered by the German Investment Fund Association (BVI), which also includes German subsidiaries in Luxembourg, lists 38 HFs at the end of 2008, with total assets under management of €1.5 billion. None of these funds is known for following an active investor approach.

A comprehensive overview of HF activity in German companies does not exist. Achleitner et al (2009) have analysed 96 cases of HF investments in listed German companies between 1998 and 2007. In total, 90% of the identified investments took place in the last three years of this period (2005–2007). Using a different data source and methodology, Becht et al (2010) identified 43 instances of HF activising in Germany between 2000 and 2008. In addition, there are several case studies for HF activities in companies like TUI AG, Cewe Color AG, Schefenacker AG and KUKA AG (Wilke et al, 2009).

*Sovereign wealth funds*

A detailed statistical overview on SWF activities in Germany is not currently available. A recent report by Deutsche Bank identified a total of €5.1 billion SWF investments in German companies between 1995 and mid-2008 (by way of comparison, the figure for SWF investments in UK companies in the same period is €26 billion). Examples of long-term investments of SWFs as minority stakeholders are the investments of Kuwait and Abu Dhabi in Daimler (7% and 9% of shares respectively), Dubai VAE with 2.2% of Deutsche Bank's stock, and the recent investment of Qatar in Volkswagen AG (17%). See the case studies on the European Foundation website for other more recent investments.

*Assessment of relative importance*

PE has been growing in importance in Germany over the past few decades, particularly in mid-sized companies (*Mittelstand*) in traditional sectors. The number of very large PE investments (mega-buyouts) has remained modest compared with the number in the UK and some other European countries. The German PE Association claims that PE is currently invested in about 4,600 companies in Germany, with a total employment of about 1.2 million (i.e. roughly 3% of overall employment). Up until the crisis, activist HFs were also playing an increasing role in influencing the corporate governance and strategy of listed German companies, with Achleitner et al (2009) identifying 39 cases of investments in listed companies over 3% in 2007. Overall, the influence of PE in Germany is considerably greater than the influence of activist HFs and SWFs.

## Outcomes and effects on companies

As in many other European countries, the debate on the effects of PE and HFs in Germany has been highly polarised. On the one hand, parts of the financial and academic community have long argued that Germany needs more activity from these types of funds. In addition to the lack of risk capital for start-ups, buyout capital is needed to help deal with the succession problem for SMEs. Furthermore, it has been argued that PE is needed to help Germany in the transition to a more shareholder value-oriented capitalism. It can help conglomerates to spin off non-core businesses and assist banks in exiting from large shareholdings in industrial companies. Furthermore, these observers have argued that PE and activist HFs can help change corporate governance in a more shareholder value-friendly direction. On the other hand, trade union and other observers have strongly criticised PE and HF. The Social Democratic politician Franz Müntefering received considerable publicity, within and outside Germany, when he described these types of funds as 'locusts'.

These differing positions have been reflected in different research findings on the employment and industrial relations effects of these funds. On the one hand, the BVK lists on its website a number of cases where PE investments have led to positive results, including employment growth. On the other hand, the trade union-related Hans Böckler Foundation has published case studies of PE and HF investments which document disrespect for rights of information, consultation and co-determination along with negative effects on employment and working conditions. However, an issue with much of this case study-based information concerns the representativeness of the cases. Econometric studies on a larger number of PE deals and HF interventions could in principle address this problem of representativeness, but to date there have been very few of these studies.

*Case studies*

In the past few years a considerable collection of case studies of PE and HF involvement companies has been accumulated. The PE case studies include a wide variance in employment and industrial relations outcomes. In some cases, PE firms and the new management they install have worked closely with works councils and trade unions, both in the case of growth stories with a win-win outcome for both sides and in tougher turnaround situations where large employment reductions and the sale of divisions are involved. In other cases, an adversarial situation has arisen and works councillors complain that they have not been informed in an adequate and timely fashion about restructuring plans and that employment conditions have significantly worsened. The latter situation appears to be more common when original plans based on growth have not been successful and the strategy focus changes to cost reduction. This latter situation seems to have happened most often in the case of secondary buyouts and in firms which have been hit hard by the recent economic crisis.

Case studies on HF interventions show that there is rarely direct contact between HFs and worker representatives and that the restructuring plans of HFs do not explicitly focus on changes to employment conditions and work organisation (Wilke et al, 2009).

*Econometric studies*

With regard to the effects of PE on employment, Achleitner et al (2008) report that there are no German studies using archival data comparing PE-backed and matched companies. There are two survey-based studies in Germany on this topic. The first study, by a PE firm in 2004, found that employment growth was on average higher in 70 buyout target companies than in the control sample (4.5% against 2.2% p.a.). However, annual sales growth per employee was lower in the buyout targets than in the control sample (3.0% against 3.45% p.a.) (Deutsche Beteiligungs AG/FINANCE, 2004). The second study, sponsored by the German PE Association BVK, showed that median employment growth in target companies, excluding turnaround situations, was 4.4%; turnaround investments, however, resulted in a median employment decrease of 28.6% (PWC/BVK, 2005).

Regarding HFs, there is only one study based on a large number of activist interventions in German companies (Bessler and Holler, 2008) and a second study already mentioned above on activist HFs in a number of European countries (Becht et al, 2010). The first study shows that share price increases following a press announcement of HF acquisition of shares and that this positive return persists in the long term (defined as 100 days following the event). Regarding operating performance, the study finds that target companies tend to have lower profitability in the year prior to being a target (this result seems to contradict the theory that HFs intervene in undervalued companies) and that profitability rises significantly in the year during which the company is a target. However, this improvement does not persist beyond the target year. The second study finds that there are positive stock price returns to

investor activism and that the returns in Germany are roughly in line with returns in other European countries. Neither study reaches conclusions on the employment effects of the intervention.

**Views and actions of the social partners**

Trade unions in Germany have taken a number of actions in response to the increased activity by PE and HFs. One measure has been to increase public awareness about specific cases and to make specific demands on the government for legislative changes. These demands have been amplified by the current financial and economic crisis and the view that factors such as PE and HFs have in part caused the crisis. The DGB has long demanded stricter regulation of AIFs and rejected a self-regulating approach by the funds industry. It has blamed PE for extracting capital from portfolio companies, resulting in high debt and increased demands for profit at the expense of employees. Furthermore, according to the DGB, the activities of most PE funds destroy the culture of companies and hamper the established system of dialogue. To limit the activities of alternative funds and their influence on companies, the DGB calls for increased reporting obligations, restrictions for LBOs and special dividend payouts, special shareholder voting rights to restrain aggressive investors and a binding code of conduct for PE and HFs.

Based on the perception that an effective regulation of the financial markets can only be achieved by an international approach, German unions worked closely with other unions, especially in the EU. Together with the British TUC, the DGB has called for a financial transactions tax to limit short-term speculation on European stock markets. Furthermore, along with global unions it has demanded a stricter regulation of the financial sector.

The Hans Böckler Foundation has played a particularly active role by commissioning detailed case studies and expert opinions on changes in tax, securities and company law needed to reduce the negative activity of such funds. Trade unions have also built up networks of works councillors involved in PE and HF situations in order to exchange best practice and provide advice. The metalworkers' union, IG Metall, has experts who have developed relationships with specific PE firms and help organise 'beauty contests' between competing PE firms to see which offer the best deal for employees at the target firm.

The confederation of the employer organisations in Germany, the Bundesvereinigung der Deutschen Arbeitgeberverbände (BDA), views AIFs more positively. In its opinion, PE can be an important financier for companies and can trigger restructuring which enhances competitiveness and innovation. Additionally, the BDA emphasised that in most cases PE investments have increased the profitability of portfolio companies and thus protect jobs and promote new employment. There is little clear information on the attitude of the BDA towards HFs and SWFs.

The PE community has claimed that PE is on the whole highly beneficial for the economy and for workers. Large employment reductions are for the most part limited to turnaround situations, where such reductions are necessary in any event and PE involvement helps save the remaining jobs. The BVK, the association representing the PE industry, launched an initiative called 'We invest in Germany' with the aim of promoting the image of PE in Germany. This initiative presents best practice case studies of PE investments in Germany and is intended to demonstrate the positive influence of PE on portfolio companies. The German PE community has complained that various obstacles, for example tax rules and the regulation of PE, present a significant disadvantage for the German PE industry and thereby

reduce its positive effects. The BVK has a longstanding demand for a specific PE law which would treat PE firms differently from other investment funds, and for improvements in the framework conditions for PE in Germany (particularly in respect to tax law).

In the wake of the continuing financial crisis and the speculation against Greece and the euro, the German government has strongly promoted a new regulative framework for international financial markets. On the one hand, they have sought to develop new financial market rules in the European context and to support the European Commission proposal for the AIFM Directive. On the other hand, they have unilaterally introduced some national regulatory rules. These rules include restrictions on so-called naked short-selling and increased transparency rules for short-selling transactions.

The proposed AIFM-Directive as well as the latest unilateral German regulatory actions drew diverse responses in Germany. The German PE industry has lobbied heavily against the proposed Directive and criticised the German government for its national initiatives. According to the BVK, the Directive will cause excessive regulation and does not differentiate between the various forms of investment funds. It contends that such constraints will be intensified by the unilateral German approach in the field of short-selling. This will shift financial activities abroad and damage the German economy.

The German trade unions generally approve of the attempt to implement stricter regulatory rules for financial markets. Nevertheless, they are doubtful that the announced proposals will be implemented and call for further steps, such as a financial transaction tax.

### The present financial and economic crisis

PE and HF investment have fallen in Germany since the onset of the crisis in 2007. It is unclear what has happened regarding total SWF investment.

One sector which has been particularly affected by the crisis is the automotive supplier sector. PE had invested heavily in a number of 'Tier 1' suppliers in Germany (i.e. suppliers with direct agreements with the car manufacturers to supply automotive systems). Due to the tendency of car manufacturers to outsource production and R&D, these Tier 1 suppliers presented a growth story which interested PE firms. However, this highly cyclical sector has been hit hard by the current crisis. Many of these automotive suppliers carry high levels of debt incurred during buyouts and this has strained resources. Many suppliers have declared bankruptcy. On the other hand, the crisis has created new opportunities for those PE funds focusing on turnaround situations and HFs specialising in purchasing distressed debt.

The media industry has also been badly affected by the crisis. Advertising revenues are down sharply in television and the print media. The long-term trend towards digital/internet-based media has also created a restructuring challenge for traditional media. A number of bankruptcies have occurred in this sector, in some cases accentuated by high buyout-related debt loads.

### Conclusions

Germany is a case in which a broad variety of employment outcomes have resulted from PE, HF and (to a lesser extent) SWF investment, mediated by the strategies of the funds and features of capital markets and industrial relations. Germany represents both an opportunity and a challenge for PE, HF and SWF investors. On the one hand, there is a demand for PE (due to ownership succession in private

companies and an increasing concentration on core competencies in large firms) and opportunities for activist HFs in a financial system which has traditionally not been strongly oriented towards shareholder value. On the other hand, the legal and tax framework is less friendly than in other countries. Employees also have strong information and decision-making rights, particularly in larger companies. However, as can be seen from the growing activities of PE and HFs over the last 20 years, investment funds have not been discouraged from investing in Germany by national labour market regulation.

The German case shows that PE, HF and SWF involvement does not necessarily lead to either a win-win situation for both sides or to situations where workers are negatively affected. Rather, the outcomes appear to depend upon the economic and financial context, the willingness of investors to take into account the interests of employees and the ability of trade unions and worker representatives to assert their rights.

## The Netherlands

The Netherlands combines a highly export-oriented economy in which labour has relatively strong power and a well-developed welfare state of a corporatist nature (Katzenstein, 1985, 2003). In terms of labour and product market regulation, it has often been seen as similar to Germany. However, since the late 1990s a number of deregulatory measures have been implemented (often described as flexicurity), making it easier for employers to hire and fire workers on temporary contracts. This is reflected in the latest OECD Employment Protection Index where the Netherlands scores lower than Germany (3.8) and has reached a level (3.0) comparable to the UK and Hungary (both 2.9) (OECD, 2004).

A further characteristic of the Dutch economy is its openness to international flows of capital (Amable, 2003). Inward and outward-bound foreign direct investment (FDI) is around 75% and 100% respectively of GDP. Moreover, most of these investments are portfolio investments, showing the high degree to which Dutch companies have become mainstream elements in the investment landscape of foreign investors. Similar conclusions can be drawn on the share of foreign ownership of equity, which is well over 80%.

A further attribute is the large, sophisticated and influential financial sector. The combined size and depth of the Dutch equity and bond markets is approximately 350% of GDP, similar to that of the US and UK and well above that of Germany and France. While Dutch banks have suffered during the recent financial crisis, Dutch institutional investors, especially pension funds, are still substantial financial actors. These funds are unique in corporatist Europe in the sense that they are mandatory pre-funded old-age insurance funds which have amassed over 120% of Dutch GDP. Another measure of financial sophistication is the size of the Dutch securitisation market. Combining high indebtedness per capita and high loan-to-value ratios has resulted in the development of a securitisation industry which has securitised almost one-third of Dutch mortgages. The size of the Dutch securitisation market is approximately 25% of Dutch GDP and is comparable to that of the UK.

These structural characteristics have facilitated the operation of PE and HFs. The Netherlands was one of the first continental European targets for both Anglo–American PE and HFs (Engelen et al, 2008). Moreover, their activities have remained at a relatively high level since their first involvement in the Netherlands from the mid-1980s onwards (for PE) and early 2000s (HFs) (Bruining et al, 2005, 2010). In a recent comparative study by EVCA, the Netherlands scores just below the UK and Sweden as the third most attractive location for PE and VC activities (EVCA, 2010).

## The regulatory context

*Capital market regulation*

Foreign investments funds which aim to invest in firms established under Dutch law face no discriminatory regulation in comparison with domestic firms. They have the same right to purchase equity in unlisted firms, and the current disclosure requirements do not discriminate between types of investors (HFs, PE, SWFs, institutional investors or retail investors) or according to the nationality of the investor. The current disclosure threshold is to be lowered to 3% in response to a number of high-profile examples of HF activism (one of which is the subject of a case study in the attachment to this report, ABN Amro). The high threshold was seen to allow HFs to build up invisible positions.

A further piece of securities market regulation relevant for investors is the legal requirement to make a public bid on a listed firm once the stake of the investor has crossed a 30% threshold. The reasoning is that the purchase of such a large stake suggests a takeover may be planned and that there should be a well-regulated bidding procedure. Moreover, under new legislation, the board is granted a much longer response time (up to six months) to allow a longer search for adequate responses to hostile bids.

From the early 2000s onwards, legislation has shifted the balance from the supervisory board to shareholders and employees. Shareholders gained the right to put unsolicited items on the agenda of the general shareholder meeting (GSM) if they possessed over 1% of shares. As the related Dutch case study shows, this was the mechanism used by the UK HF TCI in its challenge to ABN Amro. Since 2008, the threshold has been increased to 3% of stock. Moreover, the two-tier board model is no longer mandatory for large limited liability companies, while the right of appointment to the supervisory board has been allocated to the GSM, albeit with a right for the works council to make a binding suggestion.

AIFs wishing to sell their investment services to Dutch customers have to gain a licence from the relevant authorities and they are then listed in a public register. Dutch capital market regulation distinguishes between providers of investment services to retail clients and to wholesale clients, but makes no distinction between Dutch and foreign funds. If a fund has less than 100 investors and if the value of the participations on offer is higher than €50,000, AIFs are not required to register in any other way. Licences are granted if AIFs can demonstrate expertise and transparency and provide a prospectus to potential customers. Foreign AIFs can satisfy licensing requirements if they are subject to adequate supervision elsewhere. The Netherlands has no legal restrictions on the ability of funds to use leverage, buy derivatives or go short (an exception was made at the peak of the recent financial crisis) (AFM, 2005).

In the case of SWFs, despite some discussions on establishing an equivalent to US regulations, there is currently no regulation in the Netherlands that explicitly targets such funds. Since SWF activity in the Netherlands is restricted to some small stakes in Dutch publicly listed firms, there is no pressing political reason to legislate. This may change in the future if SWFs start to invest substantially in the Netherlands.

*Taxation*

Taxation touches on the activities of AIFs in a number of ways. To enhance the attractiveness of the Netherlands as the location of choice of investment funds, the Ministry of Finance in 2007 introduced a so-called Exempted Investment Fund (Vrijgestelde Beleggingsinstelling, VBI). Under this facility, funds which operate in the Netherlands are exempted from corporate taxation if the fund serves as a collective

investment vehicle and has an open-ended nature. The exemption is granted on a case-by-case basis by the revenue service. There has been some uncertainty over whether AIFs were eligible, since some are organised as partnerships. The revenue service has recently formulated thresholds to determine whether it is a regular investment or merely serves tax arbitrage goals.

Simultaneously, legislation has been introduced for the taxation of the carried interest, i.e. the pre-arranged share of the return on investment of a fund which is allocated to the general partners of the fund (typically 20%). In mid-2008 the Ministry of Finance announced a proposal to tax the 'carry' as income instead of wealth. This was explicitly meant to address wider concerns over the mild fiscal treatment of the foreign PE funds. The proposal would have resulted in an increase in effective taxation from a 12% wealth tax to a maximum marginal income tax rate of 52%. This would, however, only cover the carry booked in the Netherlands and would not apply to foreign AIFs. Despite extensive criticism from the sector, the proposal was finally introduced in January 2009, albeit in a lighter version – under certain conditions, the carry is now subject to CGT of 25%.

Finally, there is the fiscal treatment of debt. The interest on debt can usually be deducted from the profits which are subject to corporate tax. The underlying rationale is the stimulation of investment in new economic activities. According to some reports, Anglo–American PE houses in particular were abusing the lenient fiscal treatment of debt to dodge taxation. Anglo–American PE funds were said to have received €400 million from the Dutch revenue service as compensation for the losses booked in 2007 by their portfolio firms. It was claimed that these losses were due to increased debt burdens arising from buyouts (Volkskrant, 2008). Several attempts to balance the fiscal treatment of equity capital versus debt capital have since been launched, but all have stumbled over the constraints of international tax law as well as fear of unwanted side effects (Vleggeert, 2009). In 2010 a government committee recommended a more equal treatment of debt and equity capital to diminish the attractiveness of highly leveraged buyouts. It is currently unclear whether these proposals will be implemented.

*Labour regulation*

The Netherlands is known for a relatively high level of employment protection. According to the Hicks Kenworthy index, which measures the weighted scorings of different countries on employment protection, level of organisation, labour representation in peak concentration, etc. on a scale of 0 (low employment protection) to 1 (high employment), the Netherlands scores 0.66. This is well above the UK and the US and similar to Germany and France (Gourevitch and Shinn, 2005; Hicks and Kenworthy, 1998). While there have been some recent legal simplifications to formal dismissals, layoffs in the Netherlands remain relatively difficult and expensive. The increased level of flexibility and mobility on Dutch labour markets is almost exclusively accounted for by the self-employed and by workers with temporary and part-time employment contracts (OECD, 2004).

Despite a relatively low level of unionisation (21%), the Netherlands has strong sectoral collective wage agreements negotiated by peak-level unions and employer organisations. These are extended by law to cover both unorganised workers and firms not represented by the peak organisations. This results in a coverage of 79%, below Sweden (90%) but higher than Germany (61%) and much higher than the other countries in this report. Since Dutch unions derive their legitimacy more from their status as reliable negotiating partners at the peak level than from aggressive mobilisation of workers on the shop floor, peak bargaining has mostly resulted in wage restraint to enhance the international competitiveness of Dutch firms (Visser and Hemerijck, 1997).

At company level, however, Dutch workers have relatively strong information and co-decision rights under the Works Council Act. Companies with more than 50 employees are obliged to provide facilities for the establishment of a works council, if requested by the workforce. Nevertheless, in practice, this means that less than half of all firms with over 50 but less than 100 workers have a works council. The proportion increases amongst firms with more than 100 workers.

Works council rights are strongest in the area of workplace-level work organisation and employment relations. Under labour law, works councils only have advisory rights on strategic issues, investments and divestments. Under corporate governance law, the works council of large limited liability corporations has the right to make a non-binding suggestion to the GSM concerning the appointment of at most one-third of the members of the board of directors. However, current employees or trade union officials are exempted from candidacy. The aim is to strengthen the link between workers and supervisors and enhance the distribution of information throughout the organisation (including the works council) without eroding the current independence of the supervisory board.

Unique in the Netherlands is the legal capability of shareholders and labour unions to initiate a legal request for a formal investigation by the Company Chamber of the Amsterdam Court when there is an irreconcilable conflict between the board of directors and other stakeholders over board decisions affecting the continuation of the firm in its current form (Van der Sangen, 2003). Recently a number of cases related to the activities of foreign AIFs have been brought before the Chamber. Attempts to extend the right to start such an investigation to works councils have not been successful.

**Investment funds**

*Private equity funds*

The Netherlands has a sizeable domestic PE industry. Domestic PE invests in more than 1,300 firms worldwide, 1,050 of which are located in the Netherlands. This means that more than 70% of all managed capital is invested in the Netherlands. Dutch portfolio firms managed by domestic PE employ 320,000 workers and generate €84 billion in turnover. The overall size of the Dutch PE market in 2008 in terms of invested capital was €7 billion, compared to €11 million in 1985. Most of this capital (€1.4 billion) came from foreign PE. Since the mid-1990s, the Netherlands has become an increasingly attractive location for foreign PE investment, especially Anglo–American PE houses.

Initially, most PE investments had domestic origins and provided seed-corn and expansion capital. From the mid-1990s onwards, however, larger buyouts began to surpass venture capital. From 2001 onwards, buyouts greatly increased due mainly to a small number of very large buyouts. Most buyouts are private-to-private buyouts of middle-sized firms, mostly in close cooperation with the incumbent management. Large public-to-private buyouts by PE houses have been rare in the Netherlands. From 1985 until the beginning of the financial crisis, there were only 13 of these. These types of buyouts are almost exclusively conducted by Anglo–American PE houses such as KKR, Apax and Centaurus, sometimes in collaboration with Dutch PE houses such as Alpinvest.

In 2009, foreign PE funds participated in 30 Dutch firms, covering 30,000 jobs and €27 billion in turnover (approximately 4.5% of GNP) (NVP, 2010). These figures encompass participation in every financing phase, from seed-corn capital to public-to-private buyouts. However, between 50% and 70% of overall annual investment goes to buyouts. PE funds are most active in producer services, consumer goods and services, and retail. Well over 60% of annual investments go to these sectors. In terms of numbers of firms, however, the distribution is more even (De Jong et al, 2007: 18ff; NVP, 2009).

*Hedge funds*
The HF industry in the Netherlands is small, consisting of approximately 25 funds with between €750 million and €1,000 million in assets under management.[17] Most of these funds pursue a long/short equity strategy, while some do flash trading and other quantitative-based strategies. More relevant for this report are foreign HFs, predominantly Anglo–American ones, pursuing activist strategies such as using voice rights to initiate changes in management strategy or pursuing event-driven strategies such as taking advantage of takeover situations. The first signs of HF activity in the Netherlands date from 2004. In that year five publicly quoted Dutch multinationals were targeted by Anglo–American HFs and since then an average of three or four have been targeted each year, including some of the largest Dutch firms (De Jong et al, 2007).

According to the limited data that are available, on five occasions an activist HF called for the sale of the firm or a break-up. On three occasions it intervened in an M&A process and required a higher offer from a bidder. On two occasions the fund wanted some say on a planned acquisition. In a further two cases it asked for better governance codes. In four cases the HF was successful. In a further five cases the aims of the fund were partially accommodated. In five cases the fund failed to achieve its aims.

The majority of activist HFs operating in the Netherlands came from the US (12) and the UK (10). Only one came from elsewhere (Monaco). In many instances (11 out of 14), activist funds act in concert. The shareholder position from which activist HFs launched their activism ranged from below 1% in two cases to more than 10% in three cases. Most instances of activism were launched by funds with 5% to 10%. This suggests that the proposal to increase the threshold to activate shareholder voice rights from 1% to 3% (see above) would have precluded HF activism in only four of the 14 cases.

*Sovereign wealth funds*
While there have been some discussions in the Netherlands about creating a US-style agency or establishing a specific code for SWFs, no substantial investments have yet taken place. Moreover, foreign portfolio investments in Dutch sovereign debt and Dutch top companies remains unmonitored as long as it remains below the 3% threshold. However, there are indications that Middle Eastern and Chinese funds are increasingly investing on the European continent (Reep, 2010). The Chinese Investment Corporation is known to possess a 0.9% stake in Royal Dutch Shell, while in 2007 another fund bought a 5% stake in the Belgium/Dutch bank insurer Fortis. Other SWF portfolio investments include Spyker and an Abu Dhabi-based private asset management fund and the stake of Singapore's Temasek in Eurocommercial. These portfolio investments have remained below the political radar until now. Recent Dutch delegations to China suggest a willingness on the Dutch side to open up the country for Chinese investments or the processing of Chinese investments by Dutch intermediaries.

### Outcomes and effects on companies

It is not easy to assess the long-term effects of foreign PE and HFs in the Netherlands, since there is hardly any longitudinal data available on the economic and employment consequences for Dutch portfolio firms. While there are no good reasons to suspect that the effects on individual firms in the Netherlands would be much different from those observed in the US, some US studies mix up VC and buyout investment. Moreover, the number and size of investments in different phases of the financing cycle, ranging from seed-corn capital to public-to-private buyouts, could well result in more positive outcomes in the US than the Netherlands.

[17] See http://www.iexprofs.nl/content/hedgefundindex.ashx.

Most relevant is the work done by the Bruining and Wright teams using the CMBOR database, which contains data of over 16,000 buyouts in the UK and Europe since the late 1970s. The findings of a 2005 analysis of data on 45 Dutch buyouts of more than €7.5 million, derived from annual reports and self-reporting, were as follows: first, regarding employment relations there was no decrease in terms of level of job protection, work conditions, employment rights, etc., nor in the size of the workforce. Second, in terms of human resource management a high use of so-called high-commitment HR policies can be observed, such as dialogue between workforce and management, no redundancy policies and guaranteed training. Third, in the field of industrial relations there are almost no negative impacts on voice rights, unionisation, union friendliness, etc.

Furthermore, buyouts left most of the employment relations practices of these firms untouched because most are determined at the sectoral or national level. Given the high level of institutionalisation of labour relations in the Netherlands, Dutch buyout firms are 'institutionally captured', as Bruining and Wright describe it, and the room for manoeuvre of new owners is limited (Bacon et al, 2009; Bruining et al, 2005). Over and above that, Bruining and Wright report some increases in the quality of HR policies pre- and post-buyout, which cannot be explained by the high degree of institutionalisation of Dutch employment and industrial relations institutions (Bacon et al, 2009). This indicates a positive effect of PE buyouts on human resource management (HRM) policies.

According to the annual reporting on Dutch PE by the industry association (Nederlandse Vereniging van Participatiemaatschappijen, NVP),[18] the employment effects of PE activities are generally positive. Survey data based on self-reporting by PE funds suggest that employment generally increases after a buyout. A little less than 80% of the firms subjected to a buyout suggested that it had had positive effect on future firm development. The advantages of a buyout are related to more investments in marketing, R&D and training. Buyouts are also seen to focus management more on costs and efficiency, while at the same time generating more commitment and loyalty on the part of workers (NVP, 2008).

However, the positive evaluations cited above have to be qualified. As the authors themselves acknowledge, the Bruining and Wright studies do not distinguish between different types of buyout (domestic, foreign) or between the capital backing the buyout – whether it is predominantly aimed at investment or at portfolio building and whether it is borrowed from banks or the bond market or provided by committed investors. These variables can be expected to impact on the nature of the buyout and hence on the effects of capital investment and labour outcomes. This is especially so because the use of debt in LBOs could make firms vulnerable to volatility in both financial markets and the wider macroeconomic context. This calls for a further analytical differentiation in types of buyouts on the basis of the mode of financing. As yet, no such data are publicly available.

The NVP survey also fails to make these distinctions and treats buyouts as a generic category. Moreover, its survey suffers from survivor bias, self-selection bias and a relatively low response rate, thereby raising questions about its generalisability. Finally, since changes in profitability and employment post-buyout are multi-causal in nature, it is difficult to attribute them to the buyout event in any robust way. The same is true for the macroeconomic effects of PE activity.

In contrast to the UK and Germany, there has been little trade union mobilisation around PE activities. Some local unions did rally around ownership events in which PE was involved and claimed that public-

[18] See http://www.nvp.nl.

to-private buyouts burdened firms with too much debt, resulting in declining investments in R&D, higher throughput and hence declining labour conditions (see the HEMA case study). Moreover, the largest Dutch union federation, FNV, has supported international protests and called on the Dutch corporate governance committee to extend the deliberation phase for the board of directors in the case of a hostile bid and to scale back minority shareholder rights (FNV, 2008). As reported in the case study, this was partly informed by the experiences of Dutch unions with the new owner, KKR, which appeared to go beyond the traditions of Dutch industrial relations and was only willing to accommodate wage demands after industrial action. However, no concerted attempts were made by Dutch unions to contest the claims made by PE industry organisations, such as the NVP and EVCA, about the beneficial effects of PE buyouts. This could either be due to lack of resources or to the Dutch corporatist setting, which allows unions strong co-decision rights at the national and sectoral level.[19]

Determining the effects of HF activism is even more difficult. Given the small number of cases and the contested nature of HF activism, it is very hard to generate robust trends from the available data. As noted above, of the 14 cases of HF activism, a little over half succeeded in at least partially realising their aims. In most of those cases, the bone of contention was strategic or corporate governance. While crucial for the long-term development of firms, these actions did not impact materially on employment conditions. Moreover, as noted above, employment conditions in the Netherlands are largely out of reach of corporate decision-makers. The one instance in which HF activism did have a material impact on employment was when ABN Amro was targeted by TCI (see case study), and that impact was indirect at most. The subsequent break-up was not on the agenda of TCI.

Despite these qualifications, there is a striking mismatch between the available empirical data on the financial and economic consequences of AIFs and the stark nature of the public debate in the Netherlands over the influx of Anglo–American funds. What is remarkable about the period between 2004 and 2007 is the negative tone with which these investors were discussed. A content analysis of newspaper reporting, as well as public announcements by the Dutch political and economic elites, suggests a coalition of liberal and social-democratic journalists, left-wing politicians, trade union officials and state functionaries. This coalition received some public backing from the old elite who perceived these investors as threatening the functioning of the Dutch 'old boys' corporate network and the interlocking directorates on which it is built (Engelen et al, 2008).

This coalition appears to be quite resistant to empirical studies stressing the beneficial effects of PE-initiated buyouts while lacking a coherent and convincing counternarrative. A good case in point was the public reception of an academic study of the effects of AIFs on the Dutch economy by the business school of Erasmus University, which was commissioned by the Ministry of Finance to present an overview of AIF activities in the Netherlands and their effects (De Jong et al, 2007). The report received strongly negative coverage on the basis of a selective reading in one of the most prominent Dutch quality dailies (*NRC Handelsblad*), while the authors were denied the chance to reply.

This suggests that the public perception of AIFs is strongly determined by a small number of high-profile cases which are seen as indicative of AIFs as a whole. In the Dutch case, these were the ABN Amro intervention by the HF TCI in 2007 and the buyout of PCM by the PE house Apax in 2004.[20] Since

[19] This is through participation in the Foundation of Labour (Stichting van de Arbeid) and the Social-Economic Council (Sociaal-Economische Raad) (see Visser and Hemerijck, 1997 for a description).

[20] See the two company case studies for more details.

PCM was at that time the owner of four of the five Dutch quality newspapers, this provided a substantial part of the more influential Dutch journalists with strong ties to politicians and other members of the political elite with real-life experience of the effects of PE buyouts. As discussed in the case study, these experiences were not representative of the wider PE universe.

These cases very much informed the re-regulatory responses to the influx of Anglo–American AIFs in the Netherlands. However, this contrasts with the simultaneous attempt by the Dutch government to market the Netherlands as an attractive international financial centre.

**The views of the social partners**

The Dutch PE community emphasises the beneficial effects of LBOs on both performance and employment of investee firms. These claims have not been consistently countered by Dutch labour organisations. FNV Bondgenoten, the largest Dutch trade union, writes on its website that it is not against PE as such, but fears negative effects in instances where firms are overburdened with debt and where PE owners demonstrate a lack of concern for the long-term profitability of the investee firm. For that reason, FNV Bondgenoten has called for more and better monitoring. Recently, as seen in the case study, two unions for workers in the media industry have filed a case against the management of PCM, one of the largest newspaper publishers, and the Apax PE fund for mismanagement. The judgment from the Corporate Chamber confirmed mismanagement and called for a broader view on the aim of PE funds. In the future, they should not only pursue financial goals but should also develop views on other performance dimensions of the investee firm. This was hailed as a victory of labour over PE funds in the Dutch press, by Dutch labour unions and on several internet sites.

Employer organisations have also voiced some concerns about speculative behaviour by foreign PEs and HFs. However, they have refrained from pushing for more regulation because, according to VNO/NCW, the biggest Dutch employers organisation, funds fulfil useful functions on capital markets. PE provides capital to firms in need of restructuring, while HFs provide liquidity to equity markets. VNO/NCW is, however, in favour of more transparency to give the incumbent management a better view on shareholder strategies and intentions.

As already shown, the HF community in the Netherlands is small and not well organised. However, there are some spokespersons who have recently gone on record to protest against the short-selling restrictions currently being debated in the EU. The AIFM Directive has faced criticism from unexpected quarters in the Netherlands. The largest pension funds, ABP and PGGM, co-managed by trade union representatives, have voiced concerns that the new requirements would raise management costs and would hence result in lower returns for Dutch pension funds, which have allocated growing amounts of capital to alternative investment classes. The lack of coordination within Dutch unions with regard to the rise of AIFs is an instance of the split nature of the Dutch political economy, combining a labour market that resembles the German one with a financial services industry that is more like the Anglo–American one.

**The present financial and economic crisis**

Since the onset of the crisis in 2007, AIF activity in the Netherlands has slowed down. HFs worldwide have taken a severe blow and HFs pursuing activist strategies have suffered even more. However, with the waning of the crisis, there are indications that activist HFs are again looking for targets. The first sign was the large stake (over 5%) which Jana Partners and Aimco took in the Dutch postal and logistics firm TNT to press for a sell-off of its postal division (FT, 2009a). Reports in the press have suggested that 2010 could bring a new wave of HF activism (FD, 2009; FT, 2009b). Another development could

be the blurring of boundaries between activist HFs and other activist investors. A case in point is the contestation over the friendly bid by the Japanese copier producer Canon for its Dutch counterpart OCE. This case suggests a rise of activism by institutional investors.

The fate of firms taken over by PE during the boom has been much more extensively discussed in the Netherlands. Attention has focused mainly on the large debts which PE has loaded onto corporations subject to public-to-private buyouts during the boom years. While indebtedness of up to 90% of total assets was not perceived as problematic pre-crisis, firms with these levels of indebtedness now face refinancing difficulties. In the case study on HEMA, former owner Maxeda has used equity capital to reduce its overall indebtedness to manageable proportions. This is a highly unusual step for PE since it reduces the leverage which in good times serves as a multiplier on the rate of return to PE houses. Another option is for borrowers to accept a loss of 30 to 60 cent per euro on the basis of a reassessment of the debt-carrying capacity of firms in a less credit-friendly environment.

A larger issue is the danger of market disturbances arising from the volume of debt which needs to be refinanced in a relatively short time span. The estimate is that €190 billion is due for rollover between 2013 and 2016 for Europe as a whole. Most of the debt was taken out at low interest rates when capital was in abundant supply. Since PE-owned firms have to compete with claims by both blue chip and sovereign borrowers, highly indebted firms may soon reach the bottom of the market and be forced to borrow at junk bond-level interest rates, with dire consequences for their solvency.

**Conclusions**

The Dutch institutional setting is characterised by relatively strict labour market regulation and very open financial markets. As a result, the Netherlands is seen by AIFs as an attractive investment target. While no robust assessments on profitability and employment effects on Dutch firms can be made from the available empirical studies, firm-level employment practices are not as susceptible to downsizing and downgrading as is claimed in some of the more alarmist reports in the Dutch media. This appears to be due to the strong degree of institutionalisation of co-determination and employment protection rights at the sectoral and national level. As a result, intra-firm re-engineering by PE appears to be restricted to financial engineering since the employment context is largely beyond managerial reach. Nevertheless, changed circumstances post-crisis might put some of the more indebted firms under future solvency stress and could hence change the overall assessment of PE in the Netherlands.

Assessing the effects of HFs’ activism is even more difficult. Since activist HFs use the voice rights of shareholders, their interventions can only address one-off strategic options such as blocking an attempted takeover, arguing for a break-up or pushing for new board members. While in half of observed cases the activists achieved some of their aims, the impact on long-term profitability is unclear.

The Dutch case is striking because of the discrepancy between the negative framing of the increasing deployment of Anglo–American AIFs in Dutch public debate and the simultaneous marketing of the Netherlands as an attractive location for mobile financial services firms, such as PE, HFs and SWFs. It is suggested that this is the effect of the hybrid nature of the Dutch political economy (Engelen et al, 2008). Striking, too, is the near-absence of a well-developed counternarrative on the part of Dutch unions to contest the claims made by industry insiders and proponents of PE and HFs. Earlier the suggestion was made that this may be due to the strongly institutionalised, but weak, nature of Dutch unions. Whatever the reason, this results in a remarkable disconnection between topical media debates on the rise of Anglo–American AIFs and a more sober, pragmatic discussion of these issues in corporatist circles.

## Sweden

Sweden has often been seen as a typical example of a corporatist country, with well-organised employer organisations, very high union density, centralised bargaining, strong employment protection, extensive social insurance and a long tradition of active labour market policies. However, much has changed in recent years, even though these characteristics still stand out. Employers' organisations have retracted from traditional corporatist institutions, union density has dropped, nationally centralised bargaining has given way to industry- and local-level bargaining and there have been noticeable cutbacks in social insurance and active labour market programmes.

The Swedish financial system has also seen significant changes in the past 30 years. At the outset, Sweden could be said to have a bank-based system of business finance, in which financing was organised between companies and their house banks. Retained earnings and bank loans were the source of most corporate sector funding and banks were a particularly important source of business finance among SMEs. This system displayed clear similarities with the systems existing in many other European countries, and in particular those of other Nordic countries (Hyytinen and Pajarinen, 2001).

However, this landscape began to change in the late 1970s. Sweden deregulated the financial sector in a series of steps removing or relaxing regulations, prices and interest rates as well as domestic and international transactions (Englund, 1990). By the late 1980s, significant steps had thus been taken in the direction of a market-based system of business investment. This development was fuelled by the crisis in the banking sector in the early 1990s – in turn partly the result of deregulation during the previous decade (Hyytinen and Pajarinen, 2001).

Today, market-based corporate financing is clearly an important part of business finance. Several large PE houses and HFs are active in Sweden. Recent estimates also indicate that the portfolio companies of these funds provide work for a sizeable number of employees.

### The institutional/mediating context

*Capital regulation*

The initial regulation of investment funds dates from the enactment of the 1974 Mutual Funds Act (*Aktiefondslagen*). This was based largely on guidelines developed by the EC and the OECD in the early 1970s. In 1990, this was replaced by the Act on Collective Investment Funds (*Lagen om värdepappersfonder*, VPFL), which in part was a reaction to the EU's passage of the UCITS Directive in 1985. Although not formally required to pass the Directive (Sweden did not join the EU until 1996), Sweden nonetheless sought to adapt local law to that of the EU. Compared with previous law, the most important changes in the VPFL enabled foreign-based funds to become active in Sweden. The most recent reformulation is the 2004 Act on Investment Funds (*Lagen om investeringsfonder*, LIF), triggered by two modifications of the original UCITS Directive in 2002 (Saalman, 2005).

Concerning the regulation of PE, the 2008 EVCA benchmarking report claims that Sweden favours investors slightly less than the European average. While Sweden is less restrictive with regard to pension funds and insurance companies' investments in VC, there are also fewer tax and fiscal R&D incentives. Thus the EVCA notes tersely that 'Sweden does not offer any tax incentives for investors, fund management companies, or funds to invest in PE and VC' (EVCA, 2008: 149). Further, although there are tax deductions available for key foreign personnel, there are no tax incentives for business R&D expenditure, R&D capital expenditure or for the creation of innovative firms. Moreover, both capital

gains and income taxes for individuals are higher than the European average. Sweden's position in the EVCA ranking, and its score on the various items, has been relatively stable since the first benchmarking report in 2003.

HFs have been allowed to operate in Sweden since the enactment of the 1990 VPFL (Saalman, 2005; SIFA, 2009). Currently, HFs are regulated under LIF, where they are classified as a type of special fund. In other words, there is no separate legislation dealing exclusively with HFs, and most of the legislation applying to other funds applies to HFs as well. The special fund status primarily involves investment rights and governance. The former refers to risk management, where special funds may deviate from the general risk requirements after obtaining permission from the Swedish Financial Supervisory Authority (SFSA). In principle, a HF may thus invest in any type of equity as long as it has obtained approval from the SFSA. The only limitations refer to equity which differs from financial instruments, e.g. raw materials and real estate (Saalman, 2005).

With permission from the SFSA, special funds such as HFs may limit their offering to special groups of investors. These groups include, among others, professional investors, investors subscribing to at least a minimum investment and foreign investors. Some HFs apply such restrictions, but others have taken the opposite tack and function in effect as mutual funds open to everybody (Saalman, 2005).

*Labour regulation*

Swedish trade unions are among the strongest in the world. Even after a slow decline from a peak in the early 1990s and a particularly sharp drop during the past five years, union density still hovers around 70%. There are, however, large variations according to industrial sector, occupation and age. Density is considerably higher in manufacturing than in services and higher in the public than in the private sector. It is also higher among white-collar than blue-collar workers and higher among older than younger workers. Nevertheless, taken as a whole, the Swedish labour force is highly unionised.

In addition, high union density is combined with relatively powerful and coherent organisation. Swedish unions are organised according to occupation and industry, not on religious or political lines. The vast majority of unions belong to one of three major confederations. In addition, Swedish employers also tend to be more organised than their counterparts in other countries, with many belonging to associations which, in turn, are organised into confederations. In this highly organised setting, three types of collective agreements may be distinguished: between union and employer confederations, between individual unions and employer organisations, and between local unions and individual employers. Although individual unions generally bargain over pay and working conditions, the confederations may coordinate the bargaining of their member unions and local branches, and employers may also supplement framework agreements signed at the higher levels through local bargaining.

The 1975 Employee Consultation and Participation in Working Life Act regulates Swedish unions' information and consultation rights. Among the Act's provisions is a requirement that employers negotiate with unions regarding important changes to the company as well as work and employment conditions. It also imposes an obligation on employers to inform unions regarding company developments with respect to production and economic prospects. In addition, employers are required to provide unions with opportunities to examine the accounts, budgets and other company materials to the extent that this is necessary for unions to safeguard the interests of their members.

The Act also regulates layoff notifications in the case of shortage of work, stipulating that, among other actions, the employer must inform the union and/or the employee in writing regarding the cause of dismissal, the number of employees to be dismissed and the duration of the notification period. Regulations regarding layoff and dismissal are also found in the Employment Protection Act (1974/1982), including the requirement that there be just cause for dismissals brought about by a lack of work and that the reasons should be related to the work of the individual employees affected. It should be noted that shortage of work not only implies a drop in sales but also changes initiated by the employer in the management of the company. Although most of the Act's provisions are mandatory, some provisions may be sidestepped through collective agreements at the sectoral and/or local level. This applies, for instance, to the order of selection for layoffs, which otherwise prioritises seniority and age.

In the latest version of the OECD's Employment Protection Index from 2003, Sweden's overall score is similar to that of other Northern countries. Sweden's score for permanent employees is somewhat higher (i.e. more protective) and for temporary workers somewhat lower than other countries in North-Central Europe. However, with regard to collective dismissals, Sweden is among the most protective countries (OECD, 2004).

**Funds**

Both PE and HFs are active in Sweden and they have been increasingly prominent since the early 1990s. PE is clearly the more important of the two, although HFs, by way of various interventions in some of the largest Swedish companies, have attracted more publicity.

*Private equity*

Almost all Swedish PE companies are members of the Swedish Private Equity and Venture Capital Association (*Svenska Riskkapitalföreningen*, SVCA). This has some 140 active (i.e. investing) PE companies and 100 associated (non-investing) members. The SVCA also has approximately 15 networks of 'business angels' among its membership. It is the primary source of information on the Swedish PE market.

Although the Swedish PE market is relatively small in absolute terms, it is the second largest in Europe (after the UK) in terms of the proportion of GDP accounted for by investments of PE funds.

Buyouts by PE funds in Sweden are primarily made by foreign PE funds. Just over 10% of buyout investments in Sweden were made by Swedish PE companies. However, some Swedish PE companies are large in an international context: in 2009, EQT and Nordic Capital were ranked by PEI 300 as among the top 50 PE firms.

PE activity has fluctuated over time. The average annual number of buyouts/buy-ins during the 15 years between 1995 and 2009 was 32. There was a marked and more or less continuous increase in activity in the late 1990s, and peaks in 2001 and 2007 with around 50 acquisitions. The character of PE investments has also changed. Initially, buyouts were almost always small acquisitions, but more recently there have been more medium and large buyouts. However, despite the rise in the average buyout value, small deals still make up the majority of acquisitions. In the peak year of 2007, 29 of the 50 buyouts/buy-ins had transaction values of €25 million or less. In general, activity has been concentrated in manufacturing (both in numbers and value), although 2006 and 2007 saw large investments in the health care sector as well (CMBOR, 2010).

The number of employees in Swedish PE and VC portfolio companies has varied over time. During the period 2001 to 2006, it fluctuated between approximately 120,000 and 170,000 workers (Nutek, 2003, 2004, 2005; SVCA, 2008). This is around 5% to 7% of the Swedish private sector workforce. However, the studies on which these numbers are based are not entirely comparable, so the figures should be taken only as rough approximations. Nonetheless, it is clear that this is a significant sector of employment in Sweden.

*Hedge funds*

The number of HFs registered in Sweden has grown from just over 10 in 2001 to around 100 in 2010. However, the proportion of capital managed by these funds has remained relatively stable at around 5% to 6% of total assets under management, at least over the period 2002 to 2007 (Nyberg, 2006). Few of the funds follow an activist approach. Although there are some high-profile HFs working in Sweden (such as Icahn Partners, Cevian and Parvus), there appear to be no studies of activist funds *per se*.

*Sovereign wealth funds*

To date, SWFs have not been a major issue in Sweden and there is little discussion of them. The current administration has expressed a generally positive attitude towards such funds, and Invest in Sweden, a government agency promoting foreign investment in Sweden, also seems interested in attracting such investment. SWFs do not appear to be an important issue for unions, while the Confederation of Swedish Enterprise has warned against automatically condemning SWFs (Svenskt Näringsliv, 2007a). The most extensive discussion of the question is a background report to the Swedish Globalization Council, a special commission set up by the current administration. Like the Confederation of Swedish Enterprise, it has cautioned against condemning SWFs (Ganslandt, 2008).

It is difficult to find information on actual investment levels. None are provided in the background report referred to above. However, according to media reports, Abu Dhabi Investment owns Swedish stock valued at SEK 11 billion (approx. €1.2 billion as at 10 September 2010), including around SEK 1 billion in each of Ericsson, HM, Nordea, TeliaSonera and Volvo. This figure would equal less than 1% of the companies' value on the stock exchange (Realtid, 2007). It has also recently been reported that another Abu Dhabi fund, Mubadala, has become a major owner of SAAB through its stake in SAAB's new owner, Spyker (Aftonbladet, 2010). However, these are rather scattered reports, and SWFs do not appear to be a major concern in the Swedish media or in political and academic debate.

*Assessment of relative importance*

Although the data on the activities of PEs and HFs is rather unsatisfactory, it seems safe to conclude that their importance has grown over the past 20 years from a base of almost zero. PE activity in terms of investments made has fluctuated in recent years, while the number of employees in portfolio companies has been more stable. Most of the buyout activity seems to have been directed at mid-sized companies and mega buyouts are virtually unknown. In contrast, activist HFs have been involved in some of the largest Swedish multinational corporations. Here the number of funds has clearly grown, yet their overall importance as a source of capital has remained stable. This would imply that their importance in terms of employment effects has also been fairly stable.

## Outcomes and effects on companies

There have been no thorough Swedish analyses on the impact of PEs and HFs on company level. The previously mentioned reports by the government agency Nutek and the SVCA are the most widely cited ones dealing with the PE industry from an employment point of view. Similarly, there seems to be no analyses of the impact of activist HFs, or of HFs in general, on employment and working conditions.

However, there is a recent union survey on the impact of PE activity on some aspects of employment relations.

*Employment and wages*

As noted, the only studies of the employment effects of PE and HF in Sweden are those by Nutek and the SVCA. They generally conclude that PE companies grow faster than all comparison groups. The most recent study examined 117 out of a sample of 136 PE companies (SVCA, 2008). The sample consisted of all SVCA members and other companies active in the Swedish PE market, and therefore includes seed, expansion and buyout PE. Data was collected through both a survey and from the portfolio companies' annual reports from a total of 1,043 Swedish and foreign portfolio companies.

The study examines employment changes between 2001 and 2006. It found that median employment growth in PE portfolio companies was 10% (SVCA, 2008). Of the PE companies studied, 66% grew, 26% shrank and the remainder saw no change. In the comparison group of companies listed on the Stockholm Stock Exchange, the highest growth was displayed by the companies on the Mid Cap list, with median growth of 4%. Companies on the Large Cap list showed no change, whereas those on the Small Cap list shrank by 4%. PE growth was particularly strong in the VC segment, with seed-corn investments displaying a rise in employment of 19%. Buyout investments also grew, but here the median employment growth was 3%. This was higher than in the comparison group of all active limited companies with a turnover of between SEK 100 million and SEK 10 billion.

It is interesting to note that portfolio companies growing organically grew slightly faster than other PE firms. This result was largely driven by relatively high organic growth among portfolio companies in the seed and expansion phase (i.e. funded by VC): in buyout situations there was no employment growth in companies that were not also engaged in acquisitions.

Similar results were obtained in earlier studies (Nutek, 2003, 2004, 2005). While these results are suggestive, the reports point out that the reference groups are not perfect. They may, for instance, differ in respect of size, sector and character. Comparisons of PE firms with more carefully defined control groups are necessary to achieve a more precise comparison.

Two studies which attempt to construct alternative comparison groups are Bergström et al (2007) and Nyrén and Åsbrink (2009). Both evaluate wage and employment developments for a set of buyout companies, compared with those of peer groups, within the same four-digit industry code (the most narrowly defined industrial categorisation available in the industrial coding scheme). Although this construction does not capture any size differences between the PE portfolio companies and their peers, it enables a more accurate analysis than the ones above in that it takes industry-specific developments into account. Life science companies would thus be compared with businesses in the same industry, rather than with all businesses of roughly the same size.

In this way, Bergström et al (2007) examined 73 buyouts between 1998 and 2006 and Nyrén and Åsbrink (2009) studied 50 primary and 22 secondary buyouts between 1998 and 2008. They compare the development of these companies with that of their 20 and 30 largest peers, respectively. In stark contrast to the studies mentioned above, neither of them found any effects of buyouts on either employment or wages. That is to say, the 'findings suggest that employment and wage levels in the buyout companies have developed in line with the peer groups' (Bergström et al, 2007: 35).

*Work, employment and industrial relations*

There is little evidence on the impact of investment funds on working conditions and employment relations. However, a survey was recently carried out among local branches of Unionen, the largest trade union in the private sector and the largest white-collar union, to find out how the PE buyout of their employer had impacted on the company and on employment relations (Unionen, 2009). This showed that a majority of the companies had undergone changes in company management as well as cost reduction programmes. Some also had activities outsourced or sold off, although the majority had not. Instead, most had made acquisitions. Most had also developed new markets and products.

With regard to employment relations, around 80% of the local unions responded that opportunities for conducting union work had improved or were unchanged. However, a minority found that they had experienced a change for the worse. Most also replied that information and consultation had remained unchanged; however, here too there was a large minority (30% to 40%) who believed that access and influence had decreased.

Although these results are very interesting, they too would be bolstered by the use of appropriately constructed comparison groups. As it stands, it is difficult to establish for certain whether the worsening of employee relations reported by the significant minority is something specific to the buyout companies, is indicative of takeovers more generally or is part of a national trend.

### Views of the social partners

The PE community is adamant that PE generates benefits for the economy in terms of growth and jobs, arguing that PE-owned companies grow faster than other companies. It also argues for various legislative changes which they believe would further support the positive role of PE. The SVCA, for instance, has argued that it should be possible to settle gains against losses for tax purposes (*kvittning*) and, together with the Confederation of Swedish Enterprise, has called for tax breaks on investments made in non-listed companies (SVCA, no date; Svenskt Näringsliv, 2007b). Participants in the Nordic Legal Project, a series of legal surveys of the Nordic VC market conducted by business representatives and coordinated by the Nordic Council of Ministers' Innovation Centre, have also called for the elimination of income taxes for foreign investors and for the removal of VAT on management services (Nordic Innovation Centre, 2009).

As for HFs, the Swedish Investment Fund Association (*Fondbolagens Förening*) seems satisfied with regulation as it stands. During discussions on the AIFM Directive, it has argued that the Swedish special fund regulations should remain intact (SIFA, 2009).

Although many are concerned about the effects of PE, Swedish trade unions can be described as cautiously positive in their attitude to PE firms. According to media reports, economists from the blue-collar confederation LO have said that PE may add value to ordinary ownership in that they may represent active owners with access to capital. The important issue for them is not who owns the company, but how they act with regard to management and their employees. They note that the Employee Consultation Act provides Swedish unions with an opportunity to be continuously involved in restructuring processes, that there is greater legal protection than elsewhere and that the social insurance system also provides better protection for employees than in most other countries in cases of restructuring. Nevertheless, they argue that risk is unevenly distributed, with managers of PE funds less exposed to risk than employees in the portfolio companies (Independent Living Institute, 2008; Sveriges Radio, 2008). It has also been observed that it is difficult to generalise, since there may be stark differences in how the buyout firms approach their portfolio companies (Unionen, 2009).

### The present financial and economic crisis

As elsewhere, the Swedish investment market was hit hard by the financial crisis and the subsequent recession. Very few new PE investments have taken place, and in the scattered investments that have occurred, there seems to be a shift away from manufacturing and into the financial sector and life sciences. There are also only a limited number of exits. Of the few sales which have taken place, many have involved losses or bankruptcy. Few new funds have been created, although this may be in part a reaction to the relatively large number of funds set up during 2008 (SVCA, 2009). There is at present no information on how HFs have operated as a result of the crisis and, as stated, SWF investments are infrequent, though they may be on the rise.

### Conclusions

From a legal perspective, the EVCA benchmarking index shows that in some respects Sweden could be perceived as not particularly attractive to PE funds. This is primarily due to what the EVCA regards as unfavourable tax treatment on expenditure and gains. These problems could be said to be exacerbated by extensive employee information and consultation rights and relatively strict employment protection legislation.

Nevertheless, despite these obstacles, Sweden attracts a substantial amount of PE investment. In fact, in relation to the size of the economy, Sweden ranks about equal with the UK, widely held to be the world's second leading PE market after the US. This would seem to suggest that either the issues mentioned by the EVCA are of lesser importance or that other factors compensate for the difficulties potentially caused by some aspects of Swedish law. It is interesting to note in these respects that the vast majority of PE investment in Sweden is made by foreign PE firms.

As for employment outcomes, there is little hard evidence, and much of the existing evidence consists of fairly simple analyses. However, it seems safe to conclude that there is at least no indication of an overall negative effect of PE and HF activity on employment and related outcomes. Even if the positive claims made by PE interest groups have received rather mixed support, there does not seem to be a clear net negative impact of PE investment on employment and industrial relations.

## Italy

Italy is usually viewed as a bank-based system of finance with largely insider corporate governance. However, although it has a dense and complex network of relations between banks and companies, it differs significantly from the countries of Northern Europe and Scandinavia with similar arrangements. In particular, Italian law does not prescribe any form of participation of workers and their representatives in the governing body of companies. Further, trade union power in Italy has weakened considerably in the last three decades, thus the role and power of Italian unions has dwindled. Company structure in Italian capitalism is also significantly different from other relational systems. These features provide an important context to the operation of new investment funds in Italy.

PE has traditionally not been strong in Italy, but developed rapidly from 2004 onwards. HFs and SWFs play only a modest role, however, and their activities are limited to the few large Italian industrial and financial groups. To understand this pattern of development, it is necessary to outline the structure of Italian companies.

Companies in the listed sector are characterised by high ownership concentration, with a large number of firms still family-owned. The free float of shares is comparatively small. In large companies, corporate agreements within a narrow elite of shareholders ('*patti di sindacato*') allow family owners to control

numerous listed and unlisted companies, often with a small shareholding. A further and related trait of Italian capitalism is low transparency. For the more critical observers, the opacity of the Italian system suggests a 'crony capitalism', where relational networks are too often equivalent to collusive networks in which conflicts of interest, widespread and undisputed, dominate in diverse forms (Rossi, 2003).

### The institutional/mediating context

From the 1990s Italian firms started to make greater use of stock market listing due to increased capital requirements in order to respond to global competition. As a result, the Italian system, like other bank-based systems, has been subject to the pressures of shareholder value and finance capitalism. In the 1990s, this was augmented by the structural crisis of the Italian economy, culminating in the exit of the lira from the European Monetary System and the adjustments needed to gain admission to the European Monetary Union. During this period policymakers came to the view that the Italian economy and its companies needed to open up to the markets and to modernise corporate governance and company control. What followed was a long series of legislative interventions in financial market regulation and company law.

*Capital regulation*

***Regulation of investment funds*** Investment funds were introduced into the Italian system in 1993 (Law No. 344). Initial legislation has gradually undergone significant amendments which have considerably expanded their scope and opportunities for use. The road chosen by the legislator was that of progressive deregulation and of strengthening contractual autonomy. The Consolidated Finance Act of 1998 eliminated the prohibition on funds from holding more than 5% or 30% of shares (depending on whether the company is listed or not). This legislation instead set general guidelines and principles and allowed the delegation of detailed regulation to secondary sets of rules issued by the government and by the Bank of Italy in its capacity as the supervisory authority for the sector.

The regulations of the Bank of Italy on collective savings management prescribes that PE and HFs can operate both with instruments such as savings management companies (*società di gestione del risparmio*, SGR) and through foreign funds (including those based in countries with more favourable tax treatment). They set out the minimum content of management regulations for each speculative fund and the timescale for approvals. The fund management regulations specify the type of assets being invested, their riskiness and the circumstances under which the prudential regulations for risk spreading and containment established by the Bank of Italy may be waived. Furthermore, investment policy must be defined consistently so that portfolio liquidity corresponds with the selected form and the time interval for redemptions.

Another significant and favourable amendment for the development of PE in Italy was the Reform of Company Law Act 2003, which removed the ban on mergers following LBOs.[21]

Finally, to provide greater protection for investors in HFs, a regulation was introduced in November 2008 which allows, in exceptional cases, a reduction in the degree of liquidity of assets held by funds. The Legislative Decree 29 November 2008/185 and the related regulations of the Bank of Italy allow the transfer of illiquid assets of speculative funds into specially constituted closed-end collective investment

[21] Previously they were deemed unlawful operations, an interpretation which was amended in 1999 by a judgment of the Court of Milan ('Treno Judgment') which recognised that their legitimacy was justified by industrial structure. The 2003 reform also abolished this latter requirement and instead prescribed a procedure for protecting partners and creditors.

funds (so-called side pocket closed-end funds) and restrict the requests for the redemption of the speculative fund in compliance with the interest and parity of treatment of the participants. The same decree also repealed the cap of 200 participants in a speculative fund previously in force.

*Corporate governance and shareholder rights*

Attempts have been made to reform Italian corporate governance but the effects of these reforms have been very limited. The Consolidated Finance Act 1998 gave a broad scope to the principle of self-regulation by the governing bodies of companies and imported the role of the independent director from the Anglo–American model. The latter role was very controversial regarding its effective independence in the Italian context. The Reform of Company Law 2003 introduced single and dual models of company board structure alongside the traditional one where the board is flanked by an external board of auditors – *collegio sindacale* – as a supervisory accounting body. Companies are free to choose which model to adopt.

To date, few companies have adopted the alternative models. Among listed companies only a handful have opted for one of the two new systems (three of the four leading Italian banks have chosen the dual model). Problems of interpretation led the Bank of Italy to issue some supervisory provisions for the credit sector: these interpret the legislation in a restrictive way by imposing restrictions on the statutory definition of competencies and on the composition of management and supervisory bodies. They therefore circumscribe the capacity for self-regulation.

Attempts have been made to strengthen the rights of minority shareholders. For example, the Law for the Protection of Savings 2005 enhanced the rights and competencies of minority interests on governing bodies. However, minority interests, and in particular investment funds, have so far not distinguished themselves by a particular activism within meetings, except in a few cases (Telecom).

*Tax law*

Legislative Decree dated 21 November 1997, No. 461 reformed the tax regime of capital gains and of the various forms of financial income, thereby modifying the tax regime of Italian registered movable funds (open-end and closed-end). In particular, the decree sanctioned the replacement of capital taxation with substitute taxation of the accrued management result achieved by the investment body over the course of each year.

A similar form of substitute taxation was also introduced for CGT and various forms of income relating to the resources and financial instruments entrusted as asset management by subjects not operating commercial enterprise activities (private individuals, non-commercial companies, simple companies and companies treated as such). To enable effective taxation, almost all capital gains are calculated before deductions and ordinarily applicable substitute taxes. This regime allows losses to be offset against surpluses and capital gains (interest, dividends, etc.).

In Italy, unlike most other countries, the taxing of income from investments in collective investment undertakings (such as PE and HFs) does not fall on the investor, but directly impacts the fund through the application of a substitute tax of 12.5% on the financial results accrued in each tax period. If, on the other hand, the financial results of the fund are negative (i.e. a decrease in the value of the capital has occurred), the fund accrues a right to pay lower taxes on subsequent capital gains. From an operational point of view, this means that for a loss accumulated gradually, the fund can credit into the account of the body on a daily basis an amount equivalent to 12.5% of the capital loss (so-called tax saving).

The fiscal and corporate reform of 2004 also introduced a more attractive tax regime for PE. In particular, the purchase of stock has been made more favourable thanks to the participation exemption on surpluses and dividends. The tax advantage (84% exemption on surpluses) has been increased to 95% with the Finance Act of 2008. The tax treatment had been seen by Italian brokers as one of the main obstacles to the development of the sector.

*Labour regulation*
1) ***Employment protection*** Article 18 of the Workers' Statute (1970) protects a worker from individual dismissal without just cause. In 2002–2003 the government tried to abolish this article, though it was prevented from doing so because of protests organised by CGIL, the largest Italian trade union. However, the article only applies to companies with over 15 employees. Given the characteristics of Italian company structure, this means that a very large proportion of workers do not fall under its protection.

Similar observations can be made for the Wages Guarantee Fund (*Cassa Integrazione Guadagni*), which guarantees temporarily unemployed workers a part of their wages when companies are in crisis. Again, the employees of the smallest companies are effectively excluded.

Starting with the 1997 Treu Law of the then centre-left government and then the so-called Biagi Law of the second Berlusconi government (2003), atypical and temporary contracts were promoted to make the labour market more flexible. These contracts lacked any form of employment protection. Job insecurity is now the norm for young workers. The Italian translation of the concept of flexicurity continues to be incomplete: historically, so-called social shock absorbers such as unemployment benefits, when given at all, are insufficient to provide effective financial security.

2) ***Information and decision-making rights*** Information rights for trade unions in collective bargaining have existed since 1975. Moreover, starting in the 1980s, forms of negotiated participation enabling information disclosure and consultation with worker representative bodies began to spread at the company level (Zanussi Electrolux remains the best-known case) and/or the sector level. Legislative Decree no. 25/2007 enacted on 22 March 2007 implemented EU Directive 2002/14/EC and strengthened the information and consultation rights of workers, while also introducing administrative sanctions for breaches of these rights. The decree applies to all enterprises employing at least 50 workers and assigns a considerable role to collective bargaining in the exercise and application of these rights. The effectiveness of these rights continues to depend on the strength and skills of the trade unions.

The Italian system of labour relations does not prescribe rights of participation in decision-making processes at the company level. The Reform of Company Law itself, despite introducing the dualistic model of board structure, explicitly rules out the possibility that employees might be part of the supervisory board.

3) ***Trade unions and collective bargaining*** There are 12 million trade union members in Italy – more than in any other country in the EU. However, with half the membership made up of pensioners, overall union density among employees is 33%.[22] Italian unions have been weakened in recent years by a number of factors. One is the structural changes that have occurred in Italian capitalism, such as

[22] ICTWSS, 'Database on institutional characteristics of trade unions, wage setting, state intervention, and social pacts,' compiled by J. Visser, Amsterdam Institute for Advanced Labour Studies AIAS University of Amsterdam, 2009.

the atomisation of production units. A further weakness is the persistent and growing division of the union movement. Leaving aside the explosion of autonomous unionism and the consequent fragmentation of representation in the public and tertiary sectors, the number of unions has increased: the three largest confederations (CGIL, CISL and UIL) have now been joined by the UGL, a confederation close to the right-wing parties. Also, in some larger establishments, the presence of Cobas, an unaffiliated union movement, is sometimes significant. Trade union divisions have also increased in qualitative terms because over the last few years differences and competition between the three largest confederations have increased significantly.

As regards collective bargaining, it is necessary to distinguish the industry (national) level from the company level. In the former, collective bargaining coverage is estimated to be around 80%, given that it reflects the application of the *erga omnes* principle of national collective agreements. Collective bargaining at company level depends instead on the presence and force of union representation in the company. This varies considerably by sector, size and locality. The proportion of workers covered by second-level bargaining is diminishing, with about three million in the private sector, equivalent to around 40% of the total.

Given the weakness of trade unions in the private sector and the limited nature of collective bargaining at company level, trade unions and their representatives have very little potential to bargain over the possible entry of funds into companies. They may be informed about the entry of PE as negotiations are underway or after the event. At best, they may be able to bargain over restructuring that follows PE investment. However, they generally lack the strength and expertise to do more. Moreover, company-level union representatives who can keep up with fund specialists are an exception, with limited time off from work and limited or nonexistent office facilities.

The entry of PE normally leads to a formalisation of industrial relations in the company. This can sometimes improve the situation of the trade unions, in particular in businesses which used to be characterised by a patriarchal leadership by the owner (or the owning family). In most cases, however, the well-established, although often informal, system of relations disappears, and thus also the basis which the company delegates and/or the external trade unions used for their work at the local level. The owner is no longer rooted locally, but far away, and sometimes the distance makes direct contacts nearly impossible. Such a development can be seen in the case of Seves: the ownership of the company became invisible and the trade unions (and the local institutions) became powerless.

### Funds

*Private equity*

At the end of 2009 the total portfolio of PE investors in Italy amounted to 1,226 active investments, with an equivalent value calculated at a cost of €19.5 billion. In all, 1,062 companies were targeted and 93% of active investments were in Italian-based companies. About two-thirds of the deals (67%) were made by private investors. The total amount of resources available for investments, net of pan-European and captive investors' resources, reached about €6.3 billion by the end of 2009. Within Europe, Italy is in the middle regarding the economic significance of PE activity. In 2008, PE investments accounted for about 0.34% of GDP (ECVA statistics).

The PE sector in Italy has three distinctive characteristics: few of the large PE funds are active in Italy, many PE activities are focused on mid-market companies and about three-quarters of buyouts are of SMEs.

*Hedge funds*

HF activity in listed Italian companies has been limited. At the end of 2008, HFs were present in a few large companies, including the Unicredit banking group and the Parmalat food company. The Zenit fund in particular has held a substantial stake in Parmalat and Benetton. In the case of Parmalat, HFs have been active over the last few years in trying to ensure that the profits generated by the company reorganised after the 2003 scandal are redistributed as dividends to the shareholders. However, the extraordinary commissioner who took control of the company has retained the support of the majority of the board of directors to put profits back into the company in order to consolidate the reorganisation. In most other listed companies, HF shareholdings are very small. Moreover, as already highlighted, the HF activism in shareholder meetings up to now has been modest overall and decidedly less than the expectations of some observers (Erede, 2008).

*Sovereign wealth funds*

SWF activity has been very low in Italy. The most significant SWF has been the Norwegian pension fund (investing through Norges Bank), which has acquired up to 4% of a range of Italian listed companies. The only other significant SWF investment is Abu Dhabi Investment Company's 2% holding in Mediaset.

*Assessment of relative importance*

Over the last few years there has been an increase in PE operations in Italy. This has been interrupted – albeit with a certain time lag compared to other countries – by the credit crunch and the financial crisis. A particular target of PE investors has been small to medium-sized companies. HFs and SWFs are concentrated in the (small) segment of large listed companies. Their impact on the structure and characteristics of the Italian economy has not been very important, and no significant tensions have been registered in the area of industrial relations arising from the activism of these two types of investment funds.

### Outcomes and effects on companies

Given the characteristics of the Italian economy, the advent of PE was a novelty. As yet, there has been very little analysis of the effects of new investment funds. In particular there has been little research and analysis into the effects on labour and employment. Systematic evidence relates exclusively to PE and refers to financing and company performance rather than labour effects.

Until the financial crisis, PE funds were viewed mainly in a positive light. Discordant voices were mostly confined to a few critical analyses in the academic world. The critics emphasised the speculative nature of PE within broader critiques of financial capitalism. Those in favour of PE note that PE is an important backer of SMEs, and that most SMEs in Italy find it difficult to grow because of financial barriers. PE can provide SMEs with finance and management know-how. By contrast, any negative implications of PE activities often arise from larger investments where the investors mainly pursue short-term speculative goals. Pontarollo and Case (2007) have therefore distinguished between good and bad PE. The following two recent pieces of empirical evidence are typical of the perception in Italy. First, in 2008 the main national financial newspaper, *Il Sole 24 Ore*, examined a sample of 25 secondary buyouts carried out between 2003 and 2007 to determine whether this 'passing from hand to hand' by PE created value for the companies purchased. The results indicated that PE creates value, but only to a small extent. The revenues of the companies exchanged between funds rose by 7.6% compared to 5.4% for the reference markets.

Second, PE buyouts often took place in the middle market, targeting precisely the emblematic companies of the 'Made in Italy' concept. While PE might have been expected to strengthen these companies, instead they are in deep crisis or have failed under the weight of the financial debt. The list of names and trademarks is significant: IT Holding (which groups together well-known trademarks like Ferré), Burani (fashion), Safilo (luxury eyewear) and Ferretti (boat-building). For instance, when Ferretti needed to recapitalise to face a dramatic decline in turnover after the credit crunch, the Candover Fund refused to intervene any further and instead exited, losing the €360 million invested in the company. It was the lending banks which saved the Ferretti group by restructuring the debt. The representative of the Ferretti family, which has a shareholding in the group and continues to manage the company, accused the PE fund of having abandoned them in a time of need (Bonafede, 2009).[23]

The three case studies are part of this 'Made in Italy' company segment. The only case which shows a positive development is the one where the PE funds took over less than 50% of the company capital and the traditional owner maintained the leadership role (Marazzi). The other two cases are evidence of negative developments: Saeco was very close to bankruptcy when Philips took it over and the trade union did not have any other choice than to accept the Dutch offer. In the case of Seves some (but not all) indicators suggest that the significant cuts and possibly even the closure of the Italian factory near Florence – and the ensuing conflicts with the trade unions and local institutions – were due less to productivity deficits or market requirements than to financial challenges facing the PE fund. The PE fund needed to reorganise its portfolio in response to the financial crisis.

The case studies on Marazzi (in tiles), Seves (especially its high-quality glass brick division) and Saeco (coffee machines) are three examples where Italian workers have been negatively affected by investment funds. Here there is evidence that firms with highly skilled Italian workforces have attempted to move production from Italy to plants elsewhere in Europe. In each instance this has led to conflict with the trade unions. In the case of Seves and Saeco, it is possible that high levels of debt associated with PE involvement accentuated economic difficulties arising from the economic downturn since 2007 to force companies to take drastic action to reduce employment in their Italian plants.

However, there is no adequate statistical evidence on the overall net employment and labour effects of new investment funds.

**The present financial and economic crisis**

However, there is evidence that some funds have closed their Italian offices and transferred business to the head office (usually London). But it must be kept in mind that the effects of the financial crisis on AIF in Italy were delayed somewhat. The year 2008 was still a record one for the financial sector, both in terms of the growth in PE investments (to over €5.4 billion, an increase of 30% on 2007) and the number of PE-backed companies (372, a 23% increase). There was a net increase of 30% in the number of PE buyouts (Italian Venture Capital and Private Equity Association (AIFI) data).

[23] The author states, 'The Ferretti case is not the only one. In Italy there are many other similar cases, where the weight of indebtedness unloaded onto the companies by PE entering into the capital could jeopardise the activity of a company that remains industrially healthy. Already Ferretti demonstrates that, when there is difficulty, the fund does not want to underwrite capital increases, but prefers to lose money. Therefore the salvation of many companies today depends only on the will of the banks to restructure the debt, whilst waiting for the economic crisis to end and for turnover and margins to bounce back' (Bonafede, 2009).

These developments have led some commentators to argue that the small scale of PE activity in Italy, and its concentration in the SME sector, reflected strengths of Italian economic structure.[24] In reality, two indicators were signalling that the crisis had already partly arrived in 2008: the amount of capital in PE funds fell by about 25% and PE funds were finding it increasingly difficult to sell portfolio companies. One of the main reasons was the drop in stock exchange listings, which in the two previous years had been the preferred outlet for the funds. Many funds therefore found themselves with portfolio companies purchased in previous years at uncompetitively high prices and encumbered by debt. Some of these portfolio companies were now in difficulty.

These problems intensified in 2009. According to AIFI data, PE and VC investments in Italy fell by 52% in 2009. The number of investments also declined. In 2009, a total of 229 companies were targeted. The largest part of the resources invested (€1.688 million) went into buyouts. Turnaround deals (€416 million) represented the second most important type, mainly due to one particularly large investment. With regard to the number of deals, the most important type were expansion deals (112 investments), although this category was also marked by a decrease of 16% compared to 2008. The least affected by the slowdown was the early stage segment (-10% in number of deals and -15% in amount invested). It represented the second must important segment in terms of numbers (79 deals).

The financial crisis adversely affected fundraising activity in 2009. A total of €957 million was raised, a 58% drop compared with 2008. The crisis also influenced divestment activity in 2009 by making exits more difficult. Although the divested amount, calculated at cost (not including capital gain), increased on 2008 (€1.821 million in 2009 compared with €1.185 million in 2008), 85% of this total was write-offs. Even in terms of numbers, write-offs were the most important type, making up 39% of total recorded divestments (143).

### Conclusions

In Italy, PE investment has increased significantly over the past decade, though from a smaller base than in other European countries. HF and SWF activity is more modest. Within the PE sector, the dominant segment has been investments in SMEs, particularly in middle-sized companies. The number of mega-deals has been modest. PE has been widely viewed as providing an opportunity for the modernisation and development of an industrial structure characterised by small companies and barriers to growth and a rather closed and opaque capitalism. The financial crisis and the consequences of the credit crunch have changed this perception to a certain degree. AIFI has emphasised the positive function of PE and the opportunities for investors. It has highlighted virtuous cases of PE investments, but these clash with the loss of credibility of the funds deriving from the unsustainable indebtedness they generated in many medium-sized companies. Public opinion, including the financial press, is now more openly critical of PE and the threat it poses to the 'Made in Italy' concept.

## Poland

In 1989, Poland began a process of economic transformation with the aim of establishing a market economy. Aggressive monetary reform, privatisation and institutional reforms were undertaken to position the country for EU membership. Due to a dynamic internal market, a qualified workforce and favourable pricing of assets, Poland was able to attract substantial FDI, both in terms of strategic industrial acquisitions and also through financial investments in the rapidly developing stock market.

[24] It has been suggested that due to the small size of companies, the credit crunch has not had an impact (editorial comment in *Il Sole 24 Ore*, 24 March 2009). In the same newspaper an article had appeared that for the same reasons and with the same arguments defined Italy as a 'happy island' in the crisis, with a market that was among the most interesting and lively because it does not suffer from the crisis of liquidity.

Following the lead of the large corporations, many mid-size companies established subsidiaries in Poland allowing them to produce for both the domestic and export markets. In addition to increasing investments from abroad, the economy was stimulated by small local companies which also quickly grew in size and market share.

PE investors started to play an active role in the country prior to EU accession in 2004 and increased their activity subsequently. Poland is now the main market for PE in Central and Eastern Europe (CEE), although investment levels remain modest in comparison to Western Europe. Numerous PE transactions in the region focused on acquiring assets previously owned by the state, especially in the 1990s, owing to the large privatisation programmes initiated at that time (see the Zelmer case study). HF and SWF activity and acquisitions in Poland have been virtually nonexistent to date (Wilke et al, 2009).

**The institutional/mediating context**

Capital and labour regulation in Poland have been modelled on other countries and also result from the implementation of EU Directives. Though they often include provisions already tried and tested in foreign jurisdictions, these regulations are not without loopholes in the Polish context.

*Capital regulation*

1) ***Regulation of investment funds*** A domestic fund structure is provided for in Polish law in the form of closed-end investment funds for non-public assets (CEIF). This structure is relatively new (2004) and is not often used in practice. Most PE funds active in Poland operate instead via Polish limited liability companies (*soółka z ograniczoną odpowiedzialnością*). In this case, a holding company based in a different European country, often Cyprus, Luxembourg or the Netherlands, is generally the owner of the shares in the Polish company.

Although Polish insurance companies can buy shares directly in PE funds, Polish pension funds cannot, since PE is excluded from the list of authorised asset classes specified in pension legislation. However, pension funds can invest indirectly in PE if the investment vehicle is a CEIF, with a limit of 10% of the pension fund's assets (EVCA and KPMG, 2008; Mergermarket, 2008). This restriction may to some extent limit PE activities in Poland by reducing the amount of funds available for investment.

Polish law does not contain definitions of HF or any provisions regarding their activities. Although foreign HFs can acquire Polish financial assets without registering with the Polish financial supervision authority, Polish institutional investors are not allowed to invest in foreign HFs. Therefore, foreign HFs wishing to operate in Poland and to collect funds from investors need to register by taking the legal form either of a limited liability company or of a regular investment fund (Antkiewicz, 2007). In the latter case, they will adopt the form of CEIF, which is regulated by the Investment Fund Law of 27 May 2004.

According to Dzierżanowski et al (2009), the recent implementation of several EU directives into Polish law resulted in easier access to capital markets for small and medium-sized companies, thereby creating more favourable conditions for the growth of PE and VC activities.[25] The 2008 EVCA benchmarking survey on legal and tax environments ranks Poland fourth out of the seven countries included in this study. However, according to Groh and Liechtenstein (2009), the country fares the worst in terms of PE attractiveness, with the lowest score among the seven countries.

[25] Public Offering Law of 29 July 2005. http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051841539. Law on the Circulation of Financial Instruments of 29 July 2005. http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051831538. Law on the Supervision of Capital Markets of 29 July 2005. http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051831537.

2) ***Shareholder rights and duties*** International standards for the protection of shareholders' rights, such as the EU Transparency Directive, have been implemented in Polish law. However, the law suffers from ambiguities and weak enforcement, resulting in several known cases of abuses of minority rights (Tamowicz and Dzierżanowski, 2002).[26] Therefore, the 2005 European Bank for Reconstruction and Development (EBRD) legal indicator survey on the protection of shareholders' rights awarded Poland 8 points out of 10 for the institutional environment, but only 4 points out of 10 for simplicity and enforceability of corporate governance legislation with respect to the protection of shareholders' rights. Dzierżanowski et al (2009) note, however, that the implementation of EU directives into Polish law markedly improved the protection of minority shareholders' rights.

3) ***Tax law*** The Polish tax system does not offer any fiscal incentives to invest in PE funds (or in HFs or SWFs). A corporate income tax rate of 19% is applied to resident companies (including those with limited liability) and to permanent establishments of foreign companies. Interest payments can be deducted from taxes only under specific conditions, and consequently EVCA judges the legal environment for deductibility of net interest expenses as unfavourable and below the European average (a factor possibly limiting the inflow of PE funds) (EVCA and KPMG, 2008). Dividends paid by Polish companies to parent EU-based companies are exempt from tax if the parent company owns at least 10% of the shares in the Polish company. Interest and royalties paid to EU-based parent companies are subject to a 5% rate, but will be fully exempt from taxes after July 2013 (EVCA, 2009b, 2009c).

While tax is to be paid on a regular basis when the investment occurs via a limited liability company, domestic investors with shares in CEIFs enjoy more preferential treatment. Furthermore, a permanent domestic establishment is required for foreign companies investing via companies, whereas this is not the case for foreign partners in CEIF PE funds (EVCA, 2006; EVCA and KPMG, 2008). Therefore, although it has not been very popular so far because it is relatively new, it is likely that PE investments in Poland will increasingly occur via CEIFs, given the tax advantages of such structures.

Polish law does not include any specific provision on carried interest, the tax treatment of which varies according to the situation. It will either be considered as a bonus related to employment income in the case where the fund manager is an individual, and therefore will be subject to progressive income tax of 18% or 32%, or in the case where the fund manager is a legal person, it will be taxed as corporate income (19%). Performance incentives for PE fund managers are compatible with Polish regulation and will commonly be paid as bonuses rather than carried interest if the fund has the legal form of a CEIF and if managed by an individual (EVCA, 2009b; EVCA and KPMG, 2008).

4) ***Constraints on foreign investment*** According to the Economic Freedom Act (2004), undertakings by foreign entities originating from the EU or the European Free Trade Agreement (EFTA) zones are regulated by the same rules as those applicable to Polish entrepreneurs. Entities from outside the EU or EFTA zones can only undertake business or acquire participation in companies having the form of a limited partnership, limited joint stock partnership, limited liability company or joint stock company (in practice, the large majority of firms have one of these legal forms). Government concessions are required for a limited number of sectors – defence, energy production and distribution, protection of persons and properties, radio and TV broadcasting, and air transport (art. 46).[27]

[26] Tamowicz and Dzierżanowski (2002) provide several examples, e.g. the case of Michelin, a majority shareholder in Stomil Olsztyn, which was able to reject the auditor proposed by minority shareholders thanks to a loophole in the law. See also Tamowicz and Przybyłowski (2006).

[27] Shipyards are not included in sectors requiring government agreement to foreign acquisition. In 2009, the government began negotiations with the SWF Qatar Investment Authority over the sale of the state-owned shipyards of Szczecin and Gdynia. No deal was reached.

*Labour regulation*

1) ***Employment protection*** Polish employment protection legislation is more permissive than in most Western European countries, scoring below these countries on the OECD index of employment protection. It is, however, in line with the Central European average (OECD, 2004).

2) ***Information, consultation and decision-making rights*** The Polish system of industrial relations is characterised by decentralisation, an individualisation of rights and a strong dependence on the Labour Code (Towalski, 2009). Union membership covers only 15% of employees, the lowest level in the seven countries included in this study. Collective bargaining covers a very limited number of industries – in total, the coverage is only 14%, also the lowest of all the countries. Overall, Poland receives the second lowest mark after the UK on the European Participation Index of employees, computed by the ETUI (2009). It thus belongs to the weaker participation rights group of the EU 27.

Board representation for employees is provided for in Polish law for state-owned and partially privatised companies, but not in private companies. Works councils can be created in companies with no trade unions since the recent application of the EU Directive on providing a national framework for information and consultation (2002/14/EC). However, these councils have limited rights to obtaining information on economic issues. They are only to be consulted on employment and restructuring issues (Fulton, 2009). Overall, therefore, Poland does not rank high in terms of labour regulation.

**Funds**

While PE investment in Poland has been rising constantly until recently, to date HF and SWF acquisitions remain small and sporadic.

*Private equity*

PE in Poland has two main origins. The first is domestic, financed through capital accumulated by individuals in the early stages of privatisation. These funds are frequently the investment vehicles for owner-managers of privatised companies who later diversified their holdings, in part by creating PE-like organisations. The second category includes financial investors which were structured as PE companies from the beginning. In turn, this category comprises four types of PE funds active in Poland: first, funds established on the basis of initial support from foreign public institutions (e.g. the Polish–American Enterprise Fund and Enterprise Investors, which manages multiple funds); second, funds established on the basis of an initial private capital investment in specialised funds (e.g. MCI or White Eagle Industries); third, subsidiaries of regional funds operating across CEE (including Poland) (e.g. Innova/98); and fourth, so-called 'business angels' (non-institutional individual investors such as the Polish Network of Business Angels) (Kornasiewicz, 2004; Próchnicka-Grabias, 2008).

PE in Poland is now well established and most PE investors belong to a professional association (Polskie Stowarzyszenie Inwestorów Kapitałowych). PE investment grew steadily during the 2000s. Accounting for only 0.07% of the national GDP in 2002, it rose to 0.22% in 2007, with €1.1 billion invested in company buyouts in that year. Total investments then decreased to €913 million in 2008 (0.17% of the GDP) and to €267 million in 2009 (CMBOR, 2010; EVCA, 2004, 2009a). Although this is a low level of PE activity in comparison with Western Europe, it has placed Poland as the leading recipient of PE investments in CEE in 2008, accounting for more than a quarter of total PE investments in the region (EVCA, 2009a). Hungary and the Czech Republic came next in terms of amounts invested.

The average size of PE transactions has also been growing since 2000, reflecting some consolidation in the sector. In 2008, almost 200 companies in CEE received PE funding, with around 60 of them in Poland (EVCA, 2009a). The leading position of the Polish market in attracting PE investments is largely attributable to the size of the country's economy. The fact that it has the biggest stock exchange in the region is another important explanatory factor, because it enlarges the scope of IPO exit opportunities for potential investors (Bartlett, 2006).

Most PE investment in Poland is in the production of consumer goods and services, including distribution (see the Zelmer case study) and in the IT and telecommunications sector (see the Sygnity and Netia case studies). Also worth highlighting is the strong presence of PE in health care, which was the largest sector by value in 2009 and which underwent substantial consolidation through so-called buy and build strategies. This is well illustrated by the example of the Mid Europa fund, which acquired and merged three large domestic health care clinic businesses in 2007 (Karsai, 2009).

PE acquisitions in the last two decades were in most cases development and growth stage investments, often associated with privatisation after 1989. However, buyout activity rose considerably in the 2000s, becoming by far the predominant form of investment in 2006 and 2007 and accounting respectively for 90% and 80% of all transactions in those two years (EVCA, 2007b, 2008).

*HFs and SWFs*

At present, HF and SWF activity in Poland is very limited. At the end of 2008 the largest equity position of HF in listed companies represented only 0.4% of the company's shares. Incidentally, HF is present in the capital of Sygnity, one of the companies surveyed in the case studies, owning an insignificant amount of shares (0.07% in 2008). HF participation in unlisted Polish companies is difficult to gauge. While data is very sparse, it seems to be confined to a small number of companies. Among the few known examples, it is worth mentioning Tiger Global, which acquired a majority of shares in the job portal Pracuj.pl and has indirect participation in the social networking portal Nasza-klasa.pl (Gazeta Wyborcza, 2008).

Turning to SWFs' involvement in Poland, the top 20 identified equity positions in listed companies were held by Norges Bank (the investment manager for the Norwegian Government Pension Fund), with stakes not exceeding a maximum of 1.5% of shares. Recently, aborted negotiations with the Qatar Investment Authority over the purchase of the publicly owned shipyards of Gdynia and Szczecin were widely publicised and commented on in the press. The exact reasons why the deal was not completed were not disclosed (WBJ, 2009; Wisniewski, 2009).

### Outcomes and effects on companies

While financial data on the volume of PE transactions in Poland is readily available, no studies have been carried out on the impact of PE activity on employment levels and working conditions. Resorting to case studies is therefore helpful in attempting to build a general picture of PE activity and its consequences on employment and restructuring practices. In view of the negligible involvement of HFs or SWFs in listed companies and given the absence of data on the few cases of participation in unlisted companies, the focus in the section below is on PE investments.

1) ***Employment relations***. An EBRD survey conducted among a sample of PE funds investing in transition countries between 1992 and 2005 suggests that in 36% of the cases, PE investors resorted to

operational restructuring, meaning changes in the strategy or in the organisation of portfolio companies (EBRD, 2006).[28] An additional 20% of the transactions consisted of M&As, while labour restructuring entailing redundancies or retraining occurred in 14% of the cases. Substantial divestments were undertaken in 9% of the investments and financial restructuring (changes in the debt structure) accounted for 8%. The survey does not mention if these types of restructuring overlap.

Taking the examples of the case studies in this report, changes in employment levels under the involvement of PE do not show any clear trend. For two of the companies surveyed, Zelmer and Netia, headcount numbers increased before falling moderately in the crisis years 2008 and 2009 to levels nevertheless still higher than those prevailing at the time of the fund entry. Concerning the third company, Sygnity, the workforce was substantially reduced by roughly one-third over a two-year period. This drastic cut can be attributed to the PE-initiated merger which failed to bring the expected synergy benefits and also to falling IT demand during the crisis.

The case of Zelmer is particularly informative with respect to staffing levels and workforce composition. In order to cope with seasonal fluctuations, the PE fund introduced the employment of temporary workers during months of peak demand. Although the headcount of permanent workers decreased overall, it was more than compensated for by the hiring of seasonal staff. The company therefore achieved higher employment levels and increased flexibility. The overall improvement of management quality also played an important role in company renewal under PE.

Evidence on levels of pay is mixed. While wage growth and bonuses have been temporarily frozen in some cases (e.g. during the financial crisis), salaries have been adjusted upward in others. To illustrate, the management board of Sygnity approved a general increase of wages in spite of financial losses during the restructuring stage. It did so to counter the risk of losing key employees who had threatened to leave following the merger. On the whole, surveyed companies monitor sector-specific wage standards and fix their pay levels either close to the average or, in the case of Netia and Zelmer, slightly above it.

At least one of the companies, Zelmer, introduced a variable portion in the remuneration package of management board members, the value of which is indexed to the company's quarterly performance. No data were available for the other cases with respect to changes in variable pay for the managerial staff. Share option schemes for senior management were introduced under PE involvement in the case of Zelmer, and renewed and intensified at Netia. A share option programme already in place at Sygnity prior to PE entry seems not to have been modified.

2) ***Work relations*** The lack of appropriate aggregate data again makes it difficult to assess PE influence on working conditions in portfolio companies. Work reorganisation seems to have often taken the form of redistributing the workforce between departments, e.g. by decreasing production workers and increasing staffing in sales and marketing teams in order to achieve strategic goals, as shown in the case of Zelmer. This often implies retraining employees and developing adequate HR training programmes. Although training schemes have been implemented in all three companies surveyed, there is nothing unique about this. Establishing employee training programmes has become increasingly popular in recent years among mid-size and large companies in both PE and non-PE owned companies.

[28] The survey was conducted among 44 PE funds in which the EBRD invested between 1992 and 2005. These funds were involved in 450 investments in 399 companies during the period, operating in Central and Eastern Europe, the Baltic states, South-eastern Europe and the Commonwealth of Independent States.

Investigating the impact on working time, it is relevant to mention the case of the Polish retail chain Zabka. The stores were acquired in 2007 by the Czech PE fund Penta Investment. Contracts linking retail stores with the parent company stipulate that the shops should be open every day of the year, including public holidays. Although Polish law forbids shops to open on public holidays, the parent company claimed this ban does not apply to its stores, taking advantage of a loophole in the Labour Code. Trade unions expressed concerns that such agreements breach employee rights, whereas some store operators have been hesitant about closing their shops on public holidays, fearing consequences from the parent company (Rzeczpospolita, 2007). In 2009, the parent company introduced an additional provision stipulating that monthly premiums will not be granted to store owners who have closed their shops on public holidays (Gazeta Wyborcza, 2009).

3) ***Industrial relations*** PE involvement in Polish companies does not appear to have been the subject of any negotiations or social dialogue at the national or industry level. The modest size of industries and services with PE funding relative to the rest of the economy, together with limited coverage of collective bargaining and low union membership, probably explains why PE involvement has not become a major industrial relations topic. In the cases surveyed, trade unions and employee representatives do not seem to have been consulted at the time of acquisition.

Considering the case study examples, when the company already had a trade union (Zelmer), no change in membership occurred. In the Zelmer example, the fund also engaged in a dialogue with union representatives, providing information on its strategy for the company development. While there are no unions in the two other companies (Netia and Sygnity), it is worth mentioning that in the latter case employees took collective action on a few occasions to protest decisions of the management board. These actions seem to have produced results, such as a wage increase (see the Sygnity case study for more details).

The fact that each headcount reduction at Zelmer was implemented in agreement with the unions is worthy of attention. Moreover, redundancies in the group took the form of voluntary programmes with severance pay and replacement services as well as early retirement benefits for senior employees. By contrast, staff reductions at Sygnity and Netia took the form of dismissals with the usual notice of termination as stipulated in the Labour Code. Therefore, the more favourable employment restructuring schemes enforced at Zelmer might be attributed to the mediating influence of unions.

*Other outcomes*

Several authors point out the instrumental role of PE funds in implementing modern methods of management in their investee companies, not least in the area of corporate governance (Dzierżanowski et al, 2009; Karsai, 2009). This view is also supported by Tamowicz (2006), who argues that PE funds in Poland played a prominent role in structuring and empowering supervisory boards of target companies, citing ComputerLand as an example (see the Sygnity case study). Although difficult to measure in practice, this may result in long-term growth of employment because the initial restructuring paves the way for sound financial and economic development of the company.

Among the three companies surveyed, the case of Zelmer is illustrative with respect to HR. At the initiative of the PE fund, HR policies were modernised, with the introduction of incentive mechanisms and workshops to develop employees' skills. The transfer of know-how occurring under PE involvement seems to be a salient feature across the CEE region. The lack of qualified management teams has been identified in several studies as a major obstacle to successful PE investments in the region.[29]

[29] Karsai (2009: 8) provides a comprehensive review of existing studies.

**Views of peak organisations and the social partners**

The Polish Private Equity Association (*Polskie Stowarzyszenie Inwestorów Kapitałowych*) supports the view that PE has a highly positive impact on the growth of investee companies and of the economy, asserting that PE focuses more on the long-term growth of portfolio companies than traditional investors normally would. It stresses that PE funds act as strategic partners and, unlike other financial investors, share their industry experience and contact network with investee companies in order to help them grow (PSIK, 2010). The Polish Private Equity Association is critical of the EU AIFM Directive, arguing that it would disrupt competition among firms by discriminating against companies with PE financing (Gazeta Wyborcza, 2009; PSIK, 2009).

Until now, the main Polish trade unions (NSZZ 'Solidarność', OPZZ and FZZ) have not formulated any official stance on the involvement of PE and HFs, possibly because of the relatively limited scope of their activity in the country. At company level there are examples of trade unions that welcomed the entry of PE into the company capital as well as instances where trade unions were more critical, thus preventing any outright generalisation. The Polish employers' organisation (Polish Confederation of Private Employers) sees PE funds as an important source of finance for Polish companies, providing alternative sources of funding to bank loans and therefore playing a useful role in the Polish economy (PKPP, 2009).

**The present financial and economic crisis**

The crisis has marked an end to the golden age of VC and PE investments in the CEE region. The outcome of the crisis for the Polish financial sector was an outflow of capital (EBRD, 2009) and, consequently, smaller amounts invested in PE transactions. The number of PE deals in Poland fell from 27 in 2007 to eight in 2009 (CMBOR, 2010). PE funds have become more cautious financially in an adverse economic environment and opportunities for profitable investments have shrunk. On the other hand, because bank loans are more difficult to obtain, more companies may have turned to PE investors for financing. Therefore, although they have more limited resources, the funds may have seen their bargaining power increase when deciding which companies to invest in (Karsai, 2009).

For target companies, one could expect additional pressure to restructure because of the crisis. Presumably these companies will have to take more serious measures if economic conditions continue to worsen, as they are bound by the profitability and exit plans of the fund. All three case study companies have reacted to the crisis by employment restructuring and layoffs. They have done so at different times, roughly corresponding to when they were impacted: autumn 2008 for Netia, summer 2009 for Zelmer and autumn 2009 for Sygnity. All three reacted to the crisis with a delay of about one quarter. Given the severity of the crisis, non-PE companies have also opted for restructuring and redundancies. A comparison with a benchmark group would be necessary to draw firm conclusions.

It is difficult to estimate to what extent restructuring decisions were taken by PE funds voicing their views at supervisory board meetings or by management boards. In some cases, where the company president is directly chosen by the fund, or as in the case of Sygnity, is even a founder of the fund, one may assume that the fund plays a major role in taking strategic decisions. However, other cases are more difficult to disentangle. For example, the Enterprise Investors fund, which holds a quasi-majority of shares in Zelmer, was very active in the year following the acquisition, but then progressively granted increased autonomy to company management. Because discussions in supervisory board meetings are not public, it is not possible to determine whether the voluntary redundancies implemented at Zelmer in 2009 can be attributed to the management board or to the PE fund.

It is also important to note that the crisis disrupted exit strategies in two ways. Either the time of exit was postponed because of a deteriorating financial position and diminishing prospects for selling the company at a good price, or, if the fund was in a difficult financial situation, the exit may have been hastened to sell off the stake to secure liquidity. This was probably the case for the Icelandic fund Novator Telecom, which abruptly exited Netia in March 2009, presumably due to the financial turmoil in Iceland.

**Conclusions**

Throughout the 1990s and the 2000s, PE funds have played an important role in Poland in financing companies in a growth phase in the context of a fast-changing economic environment following the post-1989 transformation. Not surprisingly, outcomes in terms of restructuring practices and employment levels have been mixed. From the case studies and other examples of PE investments, it would seem that in most cases PE funds have played an extensive role in shaping corporate governance and in orienting strategies of investee companies. Whether this was beneficial or not for employment and working conditions depends very much on each particular situation.

When the deal involved the acquisition of a company in its growth phase, especially in the wake of privatisation, PE involvement seems to have had a positive impact on employment levels overall. Netia and Zelmer increased their headcount overall with the exception of the crisis years. The case of Zelmer in particular is representative of a trend of PE deals in Poland in the 1990s and early 2000s, often involving privatisations and IPOs, and where target companies in most cases experienced continued growth during the PE involvement. The EVCA document *Central and Eastern Europe success stories* (2004) gives several examples of such PE acquisitions. Therefore, overall PE is likely to have played a positive role regarding employment. One reason for this was that following initial restructuring, a thriving macroeconomic environment put growth opportunities within reach of individual companies, provided that sound development strategies were implemented.[30] In this regard, PE funds seem to have helped in transferring good corporate governance practices to investee companies. In some cases (e.g. Zelmer), rises in employment were also accompanied by increased flexibility of working practices.

However, this period appears to be ending. Expansion-phase investments no longer constitute the bulk of Polish PE deals, while simultaneously the economy is maturing. Several sectors are undergoing consolidation (such as IT and telecommunications, for which the cases of Sygnity and Netia are representative) and competition is becoming tougher. Privatisation had largely ended by 2005 (Piedo, 2007), therefore limiting the scope for expansion-phase PE investments, while the recent economic crisis has ended the period of relatively high growth which began in the 1990s. Consequently, one may expect fiercer competition and, as a result, less favourable impacts on employment and working conditions in companies with PE funds among their shareholders.[31] These developments, as well as the evolving involvement of HFs and SWFs in Poland, call for further monitoring in the future.

[30] Among CEE countries, Poland fared best in terms of total economic output during the 1990s transition, and also to a large extent during the 2008–2009 crisis (IMF data).

[31] The recent opening of offices in the region by PE funds such as Carlyle Group is a sign of this tightened competition (Karsai, 2009).

## Hungary

Like Poland as considered above, Hungary has experienced changes in every economic and financial area since the old regime collapsed in 1989. Even though it is quite advanced relative to some other transition economies in terms of privatisation and building market institutions, its financial architecture is still not as developed as its counterparts in Western Europe. For example, in Hungary the ratio of stock market capitalisation to GDP is 0.24 and the ratio of private credit by banks to GDP is 0.47 (Baum et al, 2009). Most PE investment in the country has been in the form of buyouts, as with other transition countries such as Poland and the Czech Republic. Also, there are sectoral and geographical concentrations and PE investments are not distributed evenly over the entire economy.

Both regulatory institutions and the industrial relations system in Hungary are considered favourable for PE investments. There are no limitations on foreign investment and ownership, but the PE industry argues that certain aspects of company law and the tax system could be altered to make the environment more PE investment friendly. When it comes to industrial relations, Hungary is closer to the liberal economies where workers are not strongly represented at the national level. Unions are present at the shop floor and collective bargaining coverage is declining. Even though there is employee representation at the board level, in practice most decisions are made unilaterally by managers. Both the unions and the government have attempted to encourage the spread of collective agreements to the sectoral level, but so far this has not been successful.

### The institutional/mediating context

The institutional context of a country can shed light on the development of the PE and HFs and their impact on employment and social outcomes (to date, SWF involvement in Hungary has been very limited). Depending on the institutional background, certain countries have received significant amounts of investments. Since firms' decisions are affected and mediated through the institutional framework, these can be expected to influence the overall results.

*Financial market regulatory institutions*

Broadly, Hungarian civil law has a Germanic origin, which according to La Porta et al (1997) does not grant extensive rights to minority shareholders. The legal regimes are said to be effective in determining the types of investments selected and the exit strategy, such as public offerings or write-offs. Also, depending on whether the law allows for limited partnerships or not, investors could opt for different investment decisions. As early as 1988 Hungary passed company laws trying to adapt its legal structure to the needs of a private economy. Nevertheless, the 1988 Company Law was deficient in many respects and new legislation was added by the end of the 1990s. In addition, EU membership required the country to make further changes to capital market regulation. This brought Hungary more in line with other Western European countries. The general feeling is that harmonisation would be beneficial for the nation.

Domestic law in Hungary regulates PE and other investment funds. Funds which are registered are exempt from corporate income taxes. Additionally, registration allows exemptions from VAT for the management of the fund, as well as from some other restrictions applied to non-domestic entities, which in principle is favourable for investors. Yet most investors establish either a Kft (*korlátolt felelösségü társaság*) or an Rt (*részvénytársaság*) for acquisitions and do not register in Hungary. A Kft is established with a predetermined amount of initial capital (HUF 500,000; €1,771 as at 10 September 2010)

provided by its founders, and the liability of its members is limited to the amount of the company's initial capital. An Rt is established with a predetermined amount (private Rt – HUF 5 million and public Rt – HUF 20 million) and nominal value of shares. The liability of its members is limited to the provision of the nominal or issue value of the shares as well as payment of any additional capital. One of the reasons for having non-domestic limited partnerships is to avoid the establishment of a permanent base in the country. Limited partnerships are also quite common in other European countries and used extensively for PE and VC investments.

In terms of pension funds' investments, Hungarian rules and regulations are in line with those set by the EU. There are no additional restrictions on investing in VC or PE. Pension funds can invest up to 10% of their assets in Hungarian corporate bonds and 5% in AIFs. Insurance companies, however, face restrictions in Hungary when they engage in VC and PE investment funds, e.g. a maximum of 5% of funds in this asset class.

The literature examining the determinants of investment decisions by institutional investors suggests that the effective protection of shareholders' rights is highly significant. Legal protection of outside equity holders and creditor rights is low in Hungary, even compared with other transition countries. For example, Hungary ranks 119th on one recent index based on the transparency of transactions, liability for self-dealing and shareholders' ability to sue officers and directors. This is well below the OECD and European averages, indicating that shareholder rights protection leaves much to be desired in Hungary.

There have been numerous changes in corporate taxation in 2010, including an increase from 16% to 19% of corporate income tax and abolishment of employers' unemployment contribution and the so-called solidarity tax. The 10% rate for firms with a capital of at least HUF 50 million remained the same, while several tax items for small and medium enterprises were removed. Thus, the most recent developments do not indicate a uniform direction in favour of, or against, fund investments.

In conclusion, the regulatory institutions and the tax system are moderately favourable to limited partners and fund management companies. The government has attempted to improve the conditions for investment by reducing individual taxes, easing interest payment deductions and granting tax benefits for R&D expenses. Nevertheless, pension funds and insurance companies continue to experience various restrictions on VC and PE investments. There has been a debate about restricting SWF investments from non-EU nations since the financial crisis, especially for key sectors such as utilities. Lastly, there are no tax incentives to encourage investments into these areas. Given these counterbalancing tendencies in the legal and tax system, Hungary underperforms in terms of attracting investment funds. Although PE investments as a percentage of GDP exceeded the EU averages in the most recent years, improvements in the regulatory institutions and tax system could make it a more appealing market for investors.

*Labour market and industrial relations regulatory institutions*

A key characteristic of the Hungarian industrial relations system is its fragmented nature. There are six main union confederations represented in national-level frameworks. Four of these are successors of the communist unions, while two were independently created around 1988. As early as 1990, Hungary established a tripartite forum in which all the union confederations and employers' organisations were present. The National Council of Interest Reconciliation was created to resolve conflicts at the national level. This was abolished in 1998 and replaced in 1999 by the newly created National Labour Council.

Simultaneously, a new forum, the Economic Council, came into existence, which was formed to serve as a consultative forum on economic policy, not only for employees and employers but also for other institutions such as chambers of trade, representatives of multinational companies, the banking sector, etc. (Borbely, 2000). Trade union density is around 17% and collective bargaining coverage is approximately 36%, with large sectoral variations, e.g. relatively high rates in manufacturing and very low rates in services (Kohl, 2008).

Employer organisations are as fragmented as the trade unions. There are nine employer organisations represented at the national level. Membership rates are around 40% according to the latest figures (Kohl, 2008). Therefore, the Hungarian industrial relations system can be characterised as fragmented and national-level institutions as not central to policymaking.

Employees have dual representation at the workplace through unions and works councils, although the latter do not play a significant role in decision-making. Additionally, workers are also represented on company boards, but their power has been reduced by legislation passed in 2006, which enabled public companies to have single-tier boards. Employees may be represented on these boards, but there is no minimum legal standard for representation. Small companies are also not obliged to have supervisory boards. Even after the changes, private firms with at least 200 full-time employees should have a dual board system. One-third of the supervisory board must be employee representatives (Neumann, 2006). It has been suggested that the existence of supervisory boards does not automatically mean the active participation of workers in decisions. Especially with the new law, many regulations are left to decisions taken in the shareholders' meetings, and hence owners have a real say in decision-making.

The strictness of hiring and firing regulations may also have an impact on investment decisions by foreign capital. In practice, in Hungary, employment protection is among the lowest in Europe, especially for temporary workers. Protection against individual dismissals for permanent workers as well as special requirements for collective dismissals are also well below the comparable countries such as Poland and the Czech Republic. Hungary scores only 1.7 on the overall employment protection index (OECD, 2009). Small enterprises are exempt from requirements for collective dismissals. Any firm which employs fewer than 20 employees is considered small. This type of firm constitutes 43% of the value added in the economy (Marcus et al, 2008).

**Overview of funds**

IPE activity has largely been concerned with buyouts, but more recently exits have also become more significant. The main exit routes are public offerings, sales and write-offs. Unfortunately, PE and VC investments cannot be distinguished adequately since Hungarian data treats them jointly.

Since the transition, PE and VC investments in the CEE region have increased steadily, and this is especially true for Hungary. In 2006, PE and VC deals amounted to approximately 0.6% of GDP in Hungary, which was the peak (Karsai, 2009). One of the advantages that Hungary and other countries in the region experienced was rapid industrial restructuring in the 1990s. However, they were also negatively affected by the recent crisis and were to some extent considered as a risky region for further financial investments. Table 7 shows the volume and number of PE and VC investments in Hungary between 2002 and 2008.

**Table 7 Private equity and venture capital investments in Hungary**

| Year | Invested capital (€ million) | Number of investment transactions |
|---|---|---|
| 2002 | 127 | 29 |
| 2003 | 117 | 21 |
| 2004 | 108 | 41 |
| 2005 | 131 | 26 |
| 2006 | 535 | 39 |
| 2007 | 491 | 26 |
| 2008 | 515 | 25 |

Source: *HVCA annual reports*

As Table 7 shows, invested capital in Hungary has grown over the years, with the exception of 2007. The sudden rise in 2006 is due to the buyout of the delisted BorsodChem Zrt. by Permira (Karsai, 2009). In 2008, despite the world financial crisis, Hungary managed to attract significant amounts of investment. This was achieved in an environment where Europe and CEE were experiencing declines in the value of investments relative to the previous year. Moreover, the number of transactions shows that the value of each investment is growing in size. In this sense, 2008 had the highest average investment value, at around USD 20.6 million. The majority of the PE and VC investments in 2008 took the form of buyouts. In 2009, the biggest deal was the Invitel buyout, which is one of the company case studies featured in the attachment to this report.

As for the sectoral distribution of PE and VC investments in 2008, life sciences had the largest share in terms of invested capital, while the communications sector had the highest number of transactions. This divergence between the share of capital and number of transactions indicates that the latter had generally received smaller investments. Life sciences have risky and capital-intensive product development processes, hence the heavy reliance on VC investments. The large proportion of investments made in this sector could thus be mainly VC rather than PE. Besides these two, consumer goods and retail and computer and consumer electronics were important targets for PE and VC in Hungary. In the region, health care and technology, media and telecommunications attracted the highest amount of funds in 2009 while investments in manufacturing declined significantly.

HFs are a relatively recent development in Hungary; before 2005 there were no funds investing in the country. However, with changes in capital market regulations, such funds were invested at an increasing rate. Even though the crisis has had an overall negative impact on global HF performance, this type of fund continued to grow in 2009. According to industry figures, HFs saw record high levels in 2009 and the ones which invested in Hungary had the largest gains along with India. The stock market in Hungary increased in value by almost 27%, which was the major drive behind this outstanding performance (Inman, 2009). At the beginning of the 2000s, HFs benefited enormously from the privatisation of companies such as CEZ, OTP Bank and MOL. All three were exceptionally profitable until 2006, saw declines in that year, but experienced recoveries after that date.

The only major SWF activity in Hungary was the acquisition of Budapest Airport between 2007 and 2008, which amounted to USD 2.6 billion. The transaction was conducted by Hochtief Airport GmbH, which has a successful partnership with the Canadian pension fund Caisse de dépôt et placement du Québec (Caisse) and the Government of Singapore Investment Corporation (GIC) and KfW Bankengruppe (KfW IPEX-Bank).

**Outcomes and effects**

As with other transition countries, foreign investment in Hungary is significant for overall economic activity. Nevertheless, the number of companies which receive VC and PE funding is still quite small. Taken as a whole, they employ 0.2% of the labour force and generate 1.6% of revenues in the economy. Additionally, VC and PE investments in Hungary are disproportionately concentrated in the central region (Budapest and surrounding area), with about 83% of total investment. This is even the case when economic importance is controlled for, suggesting that the funds are not flowing to the other regions in Hungary despite their increasing economic growth rates. Therefore, it can be argued that even if VC and PE investments led to more employment opportunities and brought positive results, the benefits are regionally concentrated.

For some Western European countries, it has been found that the employment effects of PE are mixed, and even though some evidence has been documented for job destruction, more greenfield jobs are created as a result of PE investments. Additionally, PE is argued to have a positive association with innovation, hence stimulating technological advance, which can be beneficial in the long run. In a cross-country study including Hungary it has been pointed out that industries with higher PE investments perform better on average and lead to higher employment growth (Bernstein et al, 2010). These findings are not attributable to cycles since volatility is reduced, especially for employment. Furthermore, the authors affirm that the results are robust and reverse causality is checked, so it is not the case that PE funds choose more rapidly growing or less volatile industries.

On the other hand, based on a sample including the new EU Member States, Badunenko et al (2009) found that PE investors pick firms which have a sound financial background and which are less risky. Therefore, the superior performance of the PE-backed firms can be explained by the existing firm characteristics rather than any factors which can be attributed to investment. Also, the management structure does not seem to matter for entry. The higher labour productivity increases the likelihood of exit for the funds, indicating that they leave the company after reaping sufficient profits and sell it at its peak. Overall, Badunenko et al conclude that PE investments are not necessarily aiming to generate real value, but rather to realise financial gains. Thus, significant employment contribution from such investments is not expected.

Training activities have been found to be higher among the VC- and PE-backed companies in the EU 25 countries (CMBOR, 2008); however, this may be part of a growing trend in recent years. Employee training is gaining importance in all companies, with or without external investments. But there are also several analyses concluding either a decreasing effect of PE and VC funds on compensation or no impact. For example, a survey conducted by CMBOR shows that the real earnings of non-managerial workers increased in 51% of the cases whereas in 47% there was no change in the compensation levels (CMBOR, 2008). Unfortunately, there are no studies for Hungary looking specifically at work relations in firms which received VC and PE funds.

There is no significant difference between domestic companies which are backed by VC and PE funds in terms of the issues covered in collective bargaining. However, HRM can be quite different, especially when the investing fund has a unique country background. For example, the same practices can be copied from the parent company and implemented in Hungary as well. Collective agreements in general cover mainly traditional matters and non-wage issues are usually not discussed by the social partners. Management makes most of the decisions in these areas, but this is also the case for firms without VC and PE investments in Hungary (Fodor et al, 2008).

The three case studies also reveal some results about the PE investments in Hungary. It can be said that the size of the company as well as the sector matters for employment, work and industrial relations. In the small company Falcon-Vision, which specialises in high-technology automated vision systems, the PE investment did not lead to any significant alterations. Indeed, the investment was undertaken with the aim of expanding operations and gaining a larger presence in the CEE region. In the case of Palace Cinemas, the PE investment allowed the company to become one of the major cinema chains in the country through consolidations and acquisitions. This significantly altered work relations since multiplex cinema operations are fundamentally different from the old style one-hall movie theatres. Human resources and employment have been placed on a more systematic and professional basis. Similar standards applied to workers in all sites around the country rather than having distinct rules and regulations in each independent cinema. Finally, the Invitel case shows that PE investment can explicitly affect workforce size. In order to cut costs, the company decided to reduce the number of workers after the acquisition in 2005, but did this in consultation with the trade union.

### Views of the social partners

The biggest employer organisation in Hungary is the Confederation of Hungarian Employers and Industrialists (Munkaadók es Gyáriparosok Országos Szövetsége). Both large and small enterprises are members and it covers 50 sectoral and 16 regional associations. Since EU membership, there have been several changes to put them in line with the other Member States, and employers are concerned about developing new methods to attract investors. Among these they recommend cuts in corporate tax rates, tax exemptions for training and R&D costs and subsidies for underdeveloped regions. The employers' organisations are seeking improvements in the legal and institutional environment.

Small and medium enterprises in Hungary constitute 99.9% of all firms, employ more than two-thirds of the workforce and produce half of the gross value added. Employers' organisations are therefore concerned about PE investments which such companies can receive and ways to attract funds. In particular, SMEs can receive support for R&D expenditures and technology improvements. Lower tax rates and several tax deductions were recently introduced by the government to promote the activity of small and medium enterprises.

The government responded positively to these demands and established the Venture Finance Hungary Private Limited Company, as a member of the Hungarian Development Bank Group, in 2007. The main goal of the company is to supply SMEs with more financial resources, and funds are mainly provided by the Joint European Resources for Micro to Medium Enterprises Programmeme (Jeremie) (Kallay et al, 2008). It is a joint fund established by the EU and the Hungarian government with the purpose of increasing VC for SMEs.

The National Confederation of Hungarian Trade Unions (*Magyár Szakszervezetek Országos Szövetsége*, MSZOSZ) is the largest union confederation in terms of membership. The public sector union confederation also has a strong presence, but given that the PE investments are channelled to the private sector, MSZOSZ can be taken as the prime social partner. MSZOSZ is against the increasing trend of PE flows into the Hungarian economy. However, trade unions have not had a major influence on the regulation of PE in Hungary.

### The present financial and economic crisis

At the beginning of the crisis in the second half of 2007, Hungary and the CEE region as a whole were considered a good location for investors to diversify their portfolios. Countries in the region experienced

positive growth rates despite the credit crunch. This could be seen in the growing value of buyouts and buy-ins in the transition countries. Nevertheless, by the end of 2007 countries in the region had started to feel the crisis and the number of buyouts in the Czech Republic, Hungary, Poland and Romania fell from 56 in 2007 to 34 in 2008. Moreover, only 16 deals were recorded in 2009 (CMBOR, 2010). Also, the type of funds invested changed and investors became more interested in smaller buyouts rather than in financing firms with financial difficulties.

It has been argued that the CEE countries are especially fragile in the face of the financial crisis because they are highly dependent on foreign capital. The flow of foreign capital into these economies is crucial and most of the financial institutions are owned by foreigners. There countries face different problems, e.g. Hungary has high levels of public debt as well as a high share of foreign currency denominated loans, whereas the Baltic states suffer from large balance of payments deficits (Karsai, 2009). Some investors suggested that there are losers and winners from the crisis, with the losers having trouble attracting new funds (Squire et al, 2009). Hungary is counted among the losers, with an unstable currency and an unresolved debt problem.

Vigh (2008) argued that certain industries such as autos and chemicals would experience falls in PE investments, while health care and telecommunications would continue to lure funds. This was the case for Hungary, as the biggest investment in 2009 was €227 million in Invitel in the telecommunications sector, while other sectors received €6 million in total (CMBOR, 2010). Given the serious drop in capital flowing into Hungary and continuing macroeconomic problems, a recovery in PE investments cannot be expected in the near future.

### Conclusions

Hungary receives significant PE investments compared to its CEE counterparts and the country was an important target in the region until recently. However, the number of companies which manage to attract PE investments is small and majority of the funds are accounted for by one or two big investments. At the beginning of the transition, most of the investments were focused on buying privatised firms. In the second half of the 2000s, however, private firms also obtained funds and foreign capital. Many PE firms which specialise in the region invested in Hungary.

The influence of HF and SWF in Hungary remains small, however.

The effect of PE investment on employment, work and industrial relations has not been well studied. From the limited secondary literature and company studies, it can be observed that there has been some restructuring in the post-PE investment era. This is especially the case for upper management, but human resource practices have also been affected. Workforce reductions were also experienced due to cost-cutting measures. Unfortunately, it is difficult to make strong generalisations due to a lack of extensive data.

## US and Japan – a brief overview

In addition to the evidence from the seven European countries, a brief overview is given here of the research on investment funds and labour outcomes in the US and Japan. Again, the intention is to concentrate on the impact of AIF on labour and restructuring.

**US**

The US is credited with being the primary breeding ground for many of the innovations in financial products and practices, including VC, buyout funds and HFs. It is claimed that in the US the first HF was founded in 1949 and the first LBOs took place in 1955. In the 1980s, the first major buyout boom took place as PE fundraising increased rapidly and very large companies were bought out, the largest being RJ Nabisco for USD 31.1 billion by KKR in 1989. PE grew again in the 1990s and 2000s, with ever-larger acquisitions, including giant firms such as the utility TXU and the health care provider HCA. HFs also thrived in the US and techniques used by short-selling, activist and event-driven HFs were first developed there.[32]

The relatively early deregulation of the US financial system, as well as its fragmented regulatory system, are seen as major supporting factors for the development of PE and HFs. Legal immunities, regulatory arbitrage (e.g. between the state and federal level) and court challenges have been used at various points to facilitate innovative practices and new legal constructions. The US has also been seen as fertile ground for the development of new sources of high-risk debt, such as non-investment grade ('junk') bonds in the 1980s and syndicated and securitised leveraged loans and insurance products (e.g. swaps) thereafter. The tax deductibility of interest payments on debt also represents an incentive for LBOs. For HFs, the relative transparency of US capital markets and the low concentration of ownership were supportive factors for activist practices. Low union density, fragmentation of collective bargaining and the weakness of legal rights for employee representatives have also eased the unilateral imposition of changes in company organisation and practices.

The early and widespread activity by PE and HFs may, however, have resulted in a saturation of the US market relative to other regions. For most of the past decade, PE funds with a US focus have underperformed compared to funds with a European or Asian focus (Prequin, 2009: 96).

The majority of the econometric studies that have found a negative impact of PE investment on employment are based on US data. Perhaps the most comprehensive and sophisticated of these studies on PE to date, based on a matching of US census with ownership data, found an average cumulative two-year employment loss of 7% at PE target firms relative to controls. The same study, however, refers to creative destruction, with new jobs created in the longer run (Bernstein et al, 2010; WEF, 2008: 44).

Almost all of the large-scale econometric studies of the impact of activist HFs have also been based in the US, due in large part to the size and transparency of the US capital market. Significantly, all activist investors, including HFs, are required to file a Schedule 13d report with the SEC when they intend to try to influence management to change strategy, operations or corporate governance at the target company. The studies have generally shown positive impacts of HF activism on share price (possibly driven by the prospect of a takeover at a premium) but have come to mixed conclusions regarding the impact on operations. However, none of these studies has examined the impact on employment. There do not appear to be any studies dealing with either short-selling by HFs or event-driven strategies that relate these strategies to employment and labour outcomes.

SWFs been active in the US, but traditionally have had to be very circumspect. The US government has a legal right to veto investments by foreign entities which may acquire a controlling interest. SWFs have

[32] For two popular views of the US, see Kosman (2009) and Mallaby (2010).

played a bigger role in the US since the onset of the financial crisis through a number of large investments in troubled financial institutions such as Citigroup. As major investors in PE and HFs they will also play an indirect role through these vehicles.

Since the start of the financial crisis, controversy over the role of AIFs has increased in the US. The most prominent example of this is the HF run by Bernard Madoff, which was discovered to have fabricated gains in client accounts of almost USD 65 billion. PE has also been subject to strong criticism from trade unions, particularly the Service Employees International Union (SEIU), which has organised a number of demonstrations against them. In 2009 and early 2010, proposals were being debated in Congress and at the SEC for stronger regulation of these funds, and some of these were taken up in the financial reform bill passed in the summer of 2010.

However, there are also a number of labour-friendly PE funds in the US, such as Yucaipa, which has established good relations with unions and works closely with local representatives to implement operational changes.

**Japan**

Japan is often seen as fitting into the coordinated market economy group of countries and to be a regime where internal finance and governance predominate. In this respect it might be described as the most like Germany of all the countries in this study. However, in recent years there has been some unwinding of interlocking company and bank ownership and a significant increase in foreign portfolio ownership. Takeovers are rare and foreign and hostile takeovers are particularly rare (Aoki et al, 2007). Nevertheless, Japan is perceived as offering good opportunities for PE and HFs – there is pressure to divest parts of large companies, many founder-owned firms now face succession decisions, senior managers are often said not to pursue maximum shareholder value and shares are relatively cheap and return on equity and dividend payouts are low.

In terms of capital market regulation, there is no law directly and specifically on PE and HFs. On the other hand, anti-director and minority shareholder rights are not particularly strong and the tax regime would seem to be not unfavourable to funds. There is no law in Japan regulating foreign investments by SWFs, such as exist in the US and Germany. In terms of labour regulation, Japan scores relatively high in terms of protection of employee rights in cases of redundancy which might follow restructuring. By contrast, legal rights to information and consultation are not particularly strong. In Japan, much depends on the power of the company union and implicit understandings between managers and employees, which varies greatly between companies. In conclusion, it might be said that in Japan, formal constraints on the activity of funds exist, but informal understandings within and between firms has largely limited their activity (Inagmai and Whittaker, 2005).

PE grew in Japan in the years up to the crisis, both in terms of overseas (largely US houses such as Bain, Carlyle, Cerberus, KKR and Ripplewood, but also UK Permira) and domestic funds. PE has acquired companies in banking, mobile phone operations, call centres, retailing, fast-food restaurants, and paper manufacturing. Both foreign and domestic funds have met with much scepticism and opposition. However, it has been suggested that Japanese funds which are linked to banks may effectively utilise pre-existing social ties to promote trust (Aoki, 2010: 164).

Other factors which have constrained PE activity are as follows: Japanese banks are prepared to help related companies; companies are thought of more as communities of multiple stakeholders; a different

ethic of corporate governance; and resistance from target managers and unions. In 2005, PE deals in the US totalled around 2% of GDP, whereas in Japan they were 0.05%.

HFs also grew in the years leading up to the crisis, again with a mixture of US (Steel Partners), UK (TCI) and Japanese (Murakami) funds. They have targeted sectors such as power generation, food and electricals. HFs are said to be thwarted by cross-shareholdings, defences against M&As and cultural suspicion of what is seen as foreign short-termist aggression.

Japan does not have a SWF, though there have been suggestions that it should create one, given the size of its reserves. Foreign SWF activity has been minor in Japan compared to some countries such as the UK and Germany, but there has been some discussion about the possible entry of Chinese funds into the Japanese equity market.

There are no internationally available studies which give empirical evidence of the operation of PE in Japan. It is said that some shareholders and managers are likely to insist on maintaining jobs after sale, thereby undermining the rationale for intervention. Similarly, there is a lack of English-language studies of equity-oriented HFs, though one suggests that activism has a positive effect on returns and value (Uchida and Xu, 2008).

As for the views of the social partners, the main Japanese trade union confederation, Rengo, has been strongly opposed to both PE and HFs, believing that they increase debt and cut jobs. Rengo seems to be well abreast of developments in the US and Europe.

Since the onset of the financial and economic crisis, some PE houses and HFs have closed their operations or reduced their investments in Japan. However, Japan would still seem to offer opportunities for funds, including for SWFs, as foreign portfolio holdings increase and companies become more accountable to more demanding shareholders. In addition, mutual, pension and insurance funds are said to be putting more money into funds. Governments may also be more friendly, believing that funds may help restructure firms, clean up bad assets and increase liquidity in the system.

# Analysis and discussion 5

## A preliminary review

In recent years AIFs have grown in number, assets under management and coverage (both sectoral and geographical). For some researchers and practitioners, AIFs reflect a new form of investor fund capitalism and a key aspect of the growing financialisation of the firm. There is a growing and controversial literature, produced by practitioners (funds, business associations and trade unions), by governments and international agencies and by academics. However, the discussion above has shown that the relevant literature on funds and their efffects is diverse in terms of data and methods and somewhat contradictory in terms of findings.

This report has set out to explore whether funds have an effect on employment and labour outcomes. The aim has also been to show the differences between and within funds, both in terms of their operations and possible effects in different contexts.

To describe the basic relations this report has offered a simple framework: funds intervene in or acquire parts of the whole of a firm. They may then affect the management of the firm in general and the management of labour in particular through various mechanisms, e.g. changing time horizons, reformulating corporate strategies, altering performance management systems and varying governance and voice arrangements. These changes in turn may affect employment relations (jobs, employment levels, pay and benefits), work relations (how work is organised, the intensity of work, training) and industrial relations (employee voice arrangements, including information and consultation, board representation, works councils, collective bargaining via trade unions and broader social dialogue). Of course, other factors come into play in influencing and shaping the relationship between funds, firms and labour outcomes. This report has focused on two factors in particular: the role of financial market and labour market regulation and institutions.

Before the analysis is developed further and conclusions drawn, it is important to note the following methodological caveats. First, the evidence here is drawn from a limited number of European countries. Second, the extant data (especially statistical data) varies considerably in quantity and quality. The best data exists for PE, but even this is only for certain countries, and some of it is as produced by the PE sector itself. There is very little data available on HFs and SWFs. Third, even where data exists, there are problems of relating cause and effect, of assessing the role of other relevant factors and of dealing with the issue of the counterfactual (i.e. what might have happened to an acquired company in the absence of any intervention).

## Funds and firms – independent and intervening variables

Some brief general descriptive points need to be made about types of funds and types of firms, both in general and in the case studies. In Section 2 the different types of funds were described. It was evident that across Europe there is considerable heterogeneity within fund types. Thus, in the case of PE funds, within the case studies there are examples of funds at two extremes. Some clearly pursued a buy and flip strategy, owning firms for only a short time (see the primary PE owners in the German Edscha and ProSiebenSat1 cases and the Hungarian Falcon and Vivendi cases). Others (probably most) pursued more of a buy and build strategy, though some of these were intended and others constrained to pursue this strategy because of the lack of good exit opportunities. There is a wide spectrum between these two types.

Within equity HFs, short-selling, event-driven and activist strategies were identified, though based on the authors' initial understanding and research design this report has concentrated on activism. Even within the latter category, it might be possible to discern a spectrum between balance sheet activism, which takes a short-term view of a company in order to extract value (see the Dutch ABM Amro case), as opposed to operational activism, which takes a longer-term view of a firm and which seeks to become more a part of management to optimise value. In effect, the latter type of activism shades into PE.

There is also heterogeneity within SWFs: some pursue generalist strategies, with a wide variety of smaller investments; some of these may hold large blocks, though be relatively quiescent; still others are more specialist, acquiring all or most of a company deemed to be important for strategic development (see the UK and German case study examples).

The majority of PE houses and HFs are US based, followed by the UK, with other European funds following some way behind. PE and HFs are therefore largely, but not entirely, Anglo–American phenomena. However, such funds grew in other countries in the 2000s. SWFs have their origins in countries which have commodity wealth, which have built up trade surpluses or which have structured pension schemes so as to create large pools of government money.

In terms of trends, PE grew in a number of waves in the 1980s, 1990s and 2000s, reflecting to a large extent the availability of credit and economic growth. Through the second and third of these waves, it expanded geographically from the US to the UK and the rest of Europe and elsewhere. Equally, HFs have grown through similar waves, again reflecting credit availability and opportunities to take advantage of trades in equities and other assets. SWFs have grown since the 1990s, reflecting changes in government policy and the build-up of trade surpluses. Since 2007/2008, the number of PE houses and HFs, their leverage and total assets under management have declined. It is not possible to say what has happened to SWFs, but overall, their reserves and assets have probably not fallen to anything like the same extent.

In terms of relative magnitudes, it is difficult to come to any precise conclusions, not least because of a lack of transparency by all three sets of funds and the use of leverage by PE and HFs. Moreover, magnitudes have changed over time. Stated crudely, SWFs probably have the most by way of assets, with an estimated USD 4 trillion (Rehman, 2010). PE comes next with around USD 3 trillion in assets at its peak in 2007 (Kosman, 2009). Equity HFs are the smallest, but it is impossible to estimate the shifting size of their holdings and positions because of share borrowings and leverage.

When it comes to target firms, it is difficult to draw any simple conclusions. They are spread across most sectors and cover all sizes. In the case of PE, the size of target firms probably increased over time. In the case of PE and HFs, there has also probably been an increasing trend to look at targets in service sectors. Both PE and HFs have tended to target firms which have cash but low market value and which are deemed to be able to improve performance. By contrast, SWFs are likely to target only firms which have high market value and where this is likely to increase.

Of the 16 PE case studies, in terms of employment, the largest buyout was the AA/SAGA with around 10,000 employees; relatively small by the standard of some US and European cases.[33] On average, companies in the cases had around 3,000 employees. As for sector, eight are in manufacturing, albeit

[33] Figures are rounded up to the nearest 1,000. Exact figures are to be found in the case studies.

mainly high-tech, four services, three media and communications and one retailing. Our four HF cases (two manufacturing and two services) covered a spread. The two largest (ABN Amro and Cadbury) both entailed activism and event-driven interventions; respectively they employed 110,000 and 58,000 employees worldwide. The other two (Cewe Color and Scandia), both involving activism, employed 4,000 and 6,000 respectively. The four SWF cases (three manufacturing and one transport) all involved Gulf specialist funds which acquired all or most of the company concerned. These companies ranged in size from 22,000 to 1,000 employees.

It is argued below that PE has had the most effect on firms and their employment and labour situations, followed by activist HFs. The lesser impact of HFs is because they are relatively smaller in number and they are usually short-term investors and only minor shareholders However, at some points, activism can trigger major changes (ABN Amro) and event-driven trading can have a major effect (Cadbury). In the case of SWFs, minority investment and passive onership has had the least effect, but where a SWF acquires a large block of shares or acquires a firm outright, this has the potential to have a major effect on corporate strategy.

## Employment and labour outcomes – dependent variables

### Jobs and employment

In terms of employment, the best econometric literature comes mainly from the US and UK (Gilligan and Wright, 2008; WEF 2008; Wright et al, 2007). This suggests that PE acquisition leads to initial reductions in jobs. Some of this is outright redundancy. However, an unknown quantity is transfer of employees to other companies by further sales. In these latter cases, it is uncertain what happens to jobs. The national literature reviews carried out in this report broadly confirm this pattern. Most unambiguously, the Italian and Hungarian sections suggest an initial reduction. The UK and German sections suggest substantial variation within each country, with some PE investments which were followed by large reductions and transfers. The overall assessment for Sweden is no change and for Poland an actual increase. The company case studies of PE also suggest a reduction in employment, though there was an increase in two Swedish and two Polish cases. Roughly half the PE case studies showed transfers.

Of course, there is the question as to whether more net jobs are added over the longer term through a process of creative destruction. Some of the US econometric evidence supports this, as does rather more of the UK statistical evidence. Based on the country reviews and the case studies, it is difficult to draw firm conclusions on this. However, as suggested above, there is undoubtedly turbulence and uncertainty in employment when PE acquires a target company. As throughout, it is necessary to take account of the counterfactual and what might have happened in the absence of PE acqusition.

In the case of HF interventions, there are no statistical studies which can be used as a base. Several of the case studies (Cadbury, ABN Amro) suggest job transfers and employment reduction. Others (Scania) show a slight increase. However, as suggested earlier in this report, linkages with HF interventions are difficult to make.

In the case of SWF acquisitions of shares (in part or in whole), again there are no statistical studies which can be used. The UK P&O case suggests some small reduction in employment, but with the three German cases, any effects on outcomes are not yet known.

To summarise, there is much more information about the employment effects of PE than HFs and SWFs. Indeed, it is difficult to draw any firm conclusions about the effects of HFs and SWFs. However, the evidence on PE impacts is contradictory. As outlined in Section 4, much of the divergence of evidence on the effects of PE revolves around methodological considerations.

**Wages and benefits**

In terms of wages in PE firms relative to other similar firms, the best econometric literature is somewhat contradictory. US research (Bernstein et al, 2010) suggests that PE may have a positive effect on wage levels. UK evidence suggests that average wages tend to be lower in PE-backed firms (Amess and Wright, 2007; Wright et al, 2007). In the overviews of national literature earlier in this report, the German literature suggests a very mixed situation depending on the type of acquisition, with wages growing less in turnaround buyouts. Interestingly, the Polish and Hungarian evidence and their related company case studies suggest higher relative increases in PE-backed firms.

One clear finding from the country overviews, and the case studies featured in the attachment to this report, is that there are changes in wage payment systems – at least for some employees. Most country authors suggest this is the case and 10 of the case studies show this, with only two showing no change and four with insufficient information. It is true that pay systems were most likely to be changed for managers, but also for ordinary employees in some of the cases. There is insufficient information on the nature of the new pay systems, but it would appear that they are most likely to include profit performance and share-based pay.

In terms of benefits, one suggestion in the US and UK literature is that PE owners may put less into pension and health care schemes than other employers. For the continental European countries, national chapters and case studies provide no evidence for such developments. This is not surprising given the nature of national welfare and pension systems in these countries. It is only for the UK that changes occurred in pension schemes, at least in the AA/SAGA case. However, the authors note that this is in the context of much more general changes in pension schemes in the UK.

For HFs and SWFs, scant information is available on the impact on wages. The only case with relevant information is that of P&O in the UK, where pension schemes are reported to have deteriorated under SWF ownership, though some of these changes may have been in train before the takeover and are also part of a more general trend in the UK.

**Work organisation**

In this area, the aim was to assess whether fund intervention and ownership have an effect on how work is organised, the intensity of work and investment in human capital. As stated in Section 4, the limited statistical evidence suggests that PE may have effects on aspects of work organisation. For the UK and the Netherlands, Bacon et al (2004) and Bruining et al (2005) present evidence that PE firms use a variety of high-commitment work practices. Amess et al (2007) also found that workers in PE firms have more discretion in their work than similar workers in non-PE firms. In addition, Bacon et al (2010b) found that PE firms make wide use of high-performance work practices and are more likely to use these the longer the investment. However, it should be remembered that these studies are based on PE-supplied data.

The country reports found little additional evidence. In countries such as Germany, Hungary, the Netherlands and Poland, there is some evidence of more use of part-time and temporary working, and

this is seen in four PE company cases from these countries. In terms of work intensity, five countries suggest something of an increase (Germany, Hungary, the Netherlands, Poland and (to a lesser extent) the UK). This is supported in the PE case studies from these countries. Interestingly, however, most of the country chapters report a slight increase in training and investment in skills.

In the case of HFs and SWFs, there are no statistical studies. No evidence was found for either positive or negative effects in these areas.

**Industrial relations and employee voice**

At the stage when a new owner intervenes and acquires shares (in part or in whole), there is the question as to whether employees and their representatives are informed and consulted. In four countries (Hungary, Italy, the UK and (to a lesser extent) Poland), this seems unlikely to happen. By contrast, the company cases suggest that this does happen in the Netherlands and Sweden. However, there seems to be considerable variation, with extensive information and consultation in some cases and none in others. These findings for the UK and the CEE countries are confirmed by Bacon et al (2010a).

Two further comments are appropriate here. First, it is not known whether prior information and consultation is any less in these cases than in the case of non-fund M&As. Second, this is an area where there are two relevant EU Directives: on Safeguarding Employee Rights in the Event of Transfer of Undertakings, and on M&As. This prompts questions at least as to the differential transposition and implementation of these Directives across EU countries.

Turning to possible effects on trade unions and systems of joint consultation and collective bargaining, there is evidence that in the UK, 5% of buyouts removed union recognition, but the level of recognition later reverted to pre-buyout levels (Bacon et al, 2004). The CMBOR European survey found that managers reported that PE investment had not resulted in changes in union recognition, density or standing in the eyes of management (Bacon et al, 2010a). After buyout, managers in firms recognising unions reported an increase in consultative committees and no reductions in matters subject to joint regulation. Furthermore, managers said they regarded these as more influential on their decisions and indicated increased consultation over firm performance and future plans in the UK, Ireland and CEE countries. Again, it should be remembered that one limitation of these studies is that these views are not corroborated by employees and their representatives.

In the country sections, authors generally reported no change in union recognition after the advent of PE funds. In the UK, one instance of derecognition was cited (see the AA/SAGA case study) and in Germany and the UK some cases of bypassing union voice were noted by authors. On the whole, country authors mainly felt that processes of industrial relations under fund intervention and ownership have been reasonably cooperative. An exception to this was Italy, where more conflict was reported, and this is borne out by the case studies. Conflict, both organised and informal, was also reported in invidual cases in Germany, the Netherlands, Poland and the UK.

In the case of HFs and SWFs, very little information is available. In one German case, there was an interesting coalition between employees, their unions and local mangement against HF intervention (see Cewe Color). Though coming from countries where independent trade unions and collective bargaining are mainly not allowed, in the SWF cases featured in this report the new owners seem to have kept out of industrial relations.

**Regulatory, institutional and temporal effects – mediating variables**

Consideration is given here to three final questions. First, what effect have financial market regulations and institutions had on the entry and operation of funds? Second, what effect have labour market regulations and institutions had on the entry and operation of funds? Third, what effect has the financial and economic crisis from 2007 onwards had on the activities and operation of funds?

Financial market regulation (covering the regulation of funds, shareholder rights, tax regimes and foreign funds) clearly has an effect on funds and their growth. Hence the longstanding and relatively benign situation in the UK and the liberalisation of regimes in continental countries (see especially Germany, Hungary, Italy and Sweden) have shaped when and to what extent funds have grown. Other reasons are also operative, especially the availability of credit and the existence of investment opportunities. Information on these factors is presented in the country sections in Section 5 of this report.

With regard to the influence of labour market regulation (covering employment protection, information and consultation, employee directors and works councils, and trade union rights) and the institutions of the labour market (covering trade unions and collective bargaining), two broad conclusions are suggested.

First, the relative strength or weakness of such regulations does not seem to be a major factor in determining the overall level of fund interventions and acquisitions. It is true that Hungary, Poland and the UK have weak labour market regulation and, relative to their size and compared to similar countries, high fund activity. But countries with strong regulations and institutions, such as Germany, the Netherlands and Sweden, have also seen high levels of fund activity. Similarly, Italy, with relatively weak regulation, has comparatively low levels of fund activity.

Second, labour market regulation does seem to affect labour outcomes. Hence, from the above analysis, it would seem that in Germany, the Netherlands and Sweden there is more information and consultation of workers when funds intervene. However, even in these countries strong regulation and institutions is not a guarantee that employees will be informed and representatives consulted. In Hungary, Italy, Poland and the UK, there is much less information and consultation. It is interesting that Italy, with relatively weak formal regulation, but with a tradition of more informal protests, also evidences a high level of conflict around PE interventions. Hungary and Italy also seem to have the largest reductions in jobs and employment.[34]

Stricter labour regulation therefore does not deter funds from intervening and is not inconsistent with corporate restructuring. However, labour regulation, especially the institutions of the labour market, does give employees a voice and does affect outcomes. Put another away, funds are able and willing to adapt to different regulatory and institutional contexts. Equally, unions have adapted to funds and sometimes use their interventions to develop their own organisation.

Turning to the effects of the recent finanicial and economic crisis, the number and value of PE deals has fallen in all countries. Simultaneously, however, a consolidation of the PE industry seems to have taken place and there have been new opportunities for some funds, such as those specialising in turnaround situations. These funds will be the first to receive new financial means from investors and might benefit

[34] Interestingly, however, for Hungary and Poland it was reported that survivors saw a higher level of wage increases in PE-backed firms relative to non-PE firms.

from the economic problems of some companies. There is less evidence on equity HFs, but again it seems safe to conclude that their investments and positions have been reduced and sold off, espcially in the case of activist funds. However, again there have been new opportunities for HFs investing in distressed debt. In the case of SWFs, since the crisis, some have made major investments in banks and financial services companies, some resulting in losses in value. There may also have been some change in investment strategy by SWFs, as is suggested by the German case studies.

There has been speculation as to whether PE-owned companies are faring worse than their counterparts, not least because of the high level of debt which the former carry. The speculation is also that if PE-owned firms cannot meet their debt obligations and refinance, this could lead to bankruptcies and job loss. On the other hand, difficulty of exit may mean PE funds have to work longer with management and employees in running the firm.

PE and HFs have passed through waves of expansion and contraction in the past. Unless there are major regulatory or long-term credit market changes, it seems likely that they will expand again in the future, and there is some sign of this happening already in Poland, the Netherlands and the UK. It is likely that SWFs will grow in future relative to other funds.

## Views of the peak organisations and social partners

The views of the peak organisations and the national social partners diverge radically, as one would expect. However, there are some remarkable differences between the countries analysed. The peak organisations representing PE and HFs claim that funds do not have a negative effect on employment, work or industrial relations. Rather, they provide a useful economic function by restructuring firms, improving management and increasing liquidity and capital allocation. This benefits employees and their pension funds. BusinessEurope and national business associations take a largely positive attitude to PE and SWFs (if indeed they have any views on the latter), but are rather less enthusiastic about HFs. For their part, trade unions have been opposed to PE and even more to HFs, but up to now have taken a rather more positive attitude to SWFs. To date, social dialogue between parties at EU and national level has been notable by its absence.

Trade unions are much less homogenous in their views on PE and HF. In general they are more critical and often highlight the expected negative effects on labour after PE and HF investments. However, these fears mainly play a role in Germany, Italy and the UK. Contrary to this, the attitude of trade unions in the Netherlands and Sweden is almost neutral. In Hungary and Poland, the role of PE and HFs are seen as positive by trade unions.

# The policy debate regarding the regulation of investment funds

6

## The proposed Directive on Alternative Investment Fund Managers (AIFM)

In 2009 the European Commission proposed a Directive on AIFMs 'with the objective of creating a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level'. The intention was to create new regulatory standards and to improve the transparency of funds towards investors and public authorities. A further goal was to give Member States a better economic oversight of the sector and to allow action as necessary for the better functioning of financial markets.

The proposal was strongly influenced by the economic and financial crisis and the belief that international financial markets are in need of greater regulation. Some policymakers thought that the risks associated with investment funds could also have systemic consequences for the whole international financial system. Thus, simultaneously, at the international level, the G8 and G20, the International Organisation for Securities Commissions (IOSCO) and the Financial Stability Board discussed various actions. In addition, some national governments planned stricter regulation of financial organisations. In this context, the AIFM Directive is part of an attempt to develop a legal framework for the regulation of the European financial market.

Under the Directive, the EC defines AIFs as funds which are not already harmonised under the existing Undertakings for Collective Investment in Transferable Securities (UCITS) Directive.[35] It is estimated that in 2008 the sector to be regulated had €2 trillion in assets under management. It included PE, HFs, commodity funds, real estate funds and infrastructure funds. However, SWFs are not covered.

The EC sets the following specific objectives of the AIFM Directive:

- to ensure that AIFMs are subject to appropriate authorisation and registration requirements;
- to provide for monitoring macro-prudential risks, e.g. through sharing relevant data;
- to improve risk management and organisational controls to mitigate micro-prudential risks;
- to enhance investor protection;
- to improve public accountability for AIFs holding controlling stakes in companies;
- to develop a single market for AIFMs.

The Directive adopts an approach which does not regulate the different AIFs themselves, but is aimed at the managers of these funds (the so-called AIFM). The latter are seen as responsible for all key decisions in relation to the management of the fund. 'Financial stability and investor risks stem primarily from the conduct and organisation of the manager and the providers of key services, notably the depositary and valuation agents.' An AIFM is 'any legal or natural person whose regular business is to manage one or several AIFs'. The proposal does not impose registration requirements directly on funds, nor does it regulate investment policies. The proposal therefore has a largely indirect impact on the way that funds are managed. However, it is intended to ensure that authorities are better informed about the funds marketed in the EU.

[35] The UCITS Directive (Undertakings for Collective Investment in Transferable Securities) was introduced in 1985. This Directive aimed at the regulation of the management of asset investments and the protection of investors through investment limits, disclosure requirements and independent oversight. Since its introduction it has been subject to continuous updating.

In 2010, the scope of the Directive was extended to cover not only funds based in the EU but also funds based outside the EU which distribute their financial products within the EU.

**Key questions related to the Directive**

There are a number of key questions and problems discussed in the debate on the Directive.

***Should there be thresholds for AIFs?*** The original proposal of the EC included the suggestion that the Directive will only apply to AIFMs who manage AIFs over a certain threshold. Not included are AIFs with a volume of €100 million or less, or €500 million if the AIF is not leveraged and investors have no redemption rights for at least the first five years. The Commission expect that around 30% of all HF managers, managing around 90% of HF assets in Europe, will be covered. However, it is not yet known what thresholds will ultimately be included in the Directive.

***Rules for inclusion and passports?*** For inclusion under the Directive, AIFMs need to be authorised by the responsible national regulatory authority. Therefore the AIFM has to prove that he/she has adequate qualifications for managing an AIF. Generally, the distribution of an AIF is only allowed to 'professional investors' as defined in the MiFID (Markets in Financial Instruments Directive).[36] In case of admission, the AIFM will be allowed to distribute the AIF on the basis of the 'EU Passport' in the whole Community. The marketing of AIFs based outside the EU is only permitted under certain conditions, such as reciprocal arrangements with the third country or tax information sharing systems. As a consequence it is possible that the distribution of most AIFs based outside the EU will be prohibited.

***Capital requirements?*** Under the Directive, AIFMs are obliged to have equity requirements of at least €125,000 plus 0.02% of the assets under management, where those assets exceed €250 million, or, if higher, one-quarter of all operating expenses of the AIFM. In the latest amendment, equity requirements were limited to a maximum of €10 million.

***Information disclosure?*** The Directive proposes a set of transparency requirements for AIFMs. This includes disclosure requirements for the investors and the regulatory authorities. AIFMs have to inform their investors about the fund's investment strategy, use of leverage and risk management. Additionally, the AIFMs must provide the national regulatory authorities with information about the main fields of investment and the investment instruments used. In the case of leverage, further reporting obligations are required. Under stated circumstances, the responsible regulatory authority is allowed to restrict the use of leverage.

Special requirements apply to PE funds which acquire stakes greater than 30% in companies which employ more than 250 people and have an annual turnover of more than €50 million or a balance sheet of more than €43 million. These AIFs must notify the company and the shareholders of details of their shareholding, including the fund's policy for managing conflicts of interest and their development plans for the company. Requirements include reporting development plans for portfolio companies, expected progress on activities and financial affairs of the company, details on employee turnover, terminations and recruitment. This also includes reporting to employee representatives. This latter is the only section of the Directive which touches directly on employment.

[36] The MiFID is part of the EC's Financial Services Action Plan and provides for the harmonisation of investment services in the EU. The objectives of the Directive are to increase competition and consumer protection in investment services. Additionally this Directive implemented the so-called EU 'Passport' which allows the distribution of a financial product in every EU country if it is authorised in one.

***Why not regulate short-selling and remuneration?*** The Directive will only regulate areas which are specific to the AIFM sector. Problems of short-selling and remuneration are deemed not to be unique to AIFs. These concerns must therefore be addressed by other instruments which apply to all market participants.

The Commission is considering these issues as part of the ongoing reviews of the existing acquis (e.g. consultation paper on Market Abuse Directive review, which will focus on abusive short-selling). At the time of writing a final agreement in the Council has not been reached and final negotiations with the European Parliament are ongoing.

## The views of the peak organisations

The development of investor funds, their activities and the Directive have been accompanied by an extensive debate between the European Parliament, Member States and the fund industry.[37] The social partners have been involved in this debate to varying degrees.

Within the fund industry and in the UK, the proposal has led to considerable opposition and disagreement. In large part, this has been because the Directive does not differentiate sufficiently between different forms of AIFs. Thus, it is contended that provisions which are mainly directed at high-risk asset classes, such as HFs, will be imposed on other asset classes, such as VC and PE. It is argued that this will result in costs without achieving appropriate improvements. It is contended that the Directive might result in a relocation of European funds from EU financial centres (above all London) to Switzerland or to non-European countries. Especially for the UK, where the financial sector employs more than one million people, such a flight could have a significant economic impact.[38] A recent study prepared for the UK FSA mentioned several possible impacts of the Directive on the European AIF industry.[39] According to this study, the proposed Directive will cause a significant reduction of available AIFs across Europe. It is estimated that 40% of the current HFs, 35% of PE funds and 19% of VC funds will no longer be available for European investors. Furthermore, the new fund obligation will give rise to compliance costs of over €300 million which will be passed on to the investors and thus reduce their returns.

The **European Trade Union Confederation** (ETUC) has a longstanding concern over the role of HF and PE. It doubts that HFs in general add value to the economy and activist HFs in particular try to force company restructuring and cash payouts (through extra dividends or share buybacks) which frequently are not in the long-term interests of companies and their employees. Although some PE firms may play a positive role through replacing bad management or bringing new capital into the company, many PE firms endanger the long-term sustainability of companies through the use of high leverage and the practice of asset stripping. Such practices make acquired companies more vulnerable to economic difficulties and result in layoffs. Frequently, workers have not been properly informed and consulted and industrial relations institutions have not been respected. The leverage used by HF and PE is also a point of concern for the stability of the financial system. SWFs, in contrast, are seen more positively since they tend to bring in new capital and invest for the longer term.

[37] Contributions are partly published under http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

[38] Speech by the Economic Secretary to the Treasury, K. Ussher MP, available on http://www.hm-treasury.gov.uk/speech_est_041207.htm.

[39] Charles River Associates, *Impact of the proposed AIFM Directive across Europe*, FSA, London, 2009. Available on http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf.

The ETUC has welcomed the initiative but suggested that the draft Directive does not go far enough on several points. First, there should be no thresholds because all AIFs should be regulated. Second, excessive leverage and asset stripping should be prohibited; thus the ETUC supports provisions through amendments which impose leverage caps and restrict capital extraction. It is pointed out that there is little reference to employee matters in the Directive. The ETUC therefore supports an amendment that strengthens workers' rights to information and consultation in the case of involvement by AIFs. Many of the amendments inserted by the European Parliament are thus supported by the ETUC.

For its part, **BusinessEurope** has a more positive attitude towards the general role of investment funds in the European economy. However, BusinessEurope suggests a clear differentiation between PE and HFs and emphasises the important role of the former as a provider of capital for companies. Particularly in the current economic climate, PE investors represent a favourable alternative. In the future, BusinessEurope expects a transition from a primarily debt-based company financing via banks to a more equity-based financing, and there is a role here for PE. Additionally it believes that PE funds can contribute to an efficient restructuring process in companies which suffer from economic problems, providing such companies with new financial resources and restructuring know-how.

Referring to this general positive attitude towards PE, BusinessEurope has some concerns regarding the proposed AIFM Directive. Although they admit an overall need for a better regulation of financial markets, they advocate a more balanced approach. In their view, the Directive will probably lead to a restriction of PE and thus to difficulties for companies regarding their financing options. This may especially affect small and innovative companies which are reliant on VC.

Furthermore, BusinessEurope criticises the disclosure requirements in the proposed Directive. According to the Directive, investment funds, such as PE, which own more than 30% of a company have to inform the company and employee representatives about their investment strategy. In the opinion of BusinessEurope such disclosures would possibly lead to a more direct interaction between the funds and the employee representatives and a danger of bypassing the company's management in the field of social dialogue. BusinessEurope supports a clear separation between ownership and management and the maintenance of customary social dialogue and communication between the social partners.

The **European Fund and Asset Management Association** (EFAMA), representing the European investment management industry, supports the idea of effective regulation of all financial players in general, but disapproves of the approach in the Directive.[40] Although the AIFM Directive came to life as a reaction to PE and HFs, it covers too broad a universe of different funds (all non-UCITS funds), and EFAMA argues that the Directive should better take into account the different characteristics of various fund types. Furthermore, with regard to activities relevant to systemic risk, market efficiency and integrity, EFAMA believes that it is the activity itself that should be regulated. Such regulation should apply to any market participant, not just AIFs. The Directive does not therefore provide a solution in regard to leverage, short-selling and raider-type activities.

Additionally, EFAMA argues that existing Directives, like MiFID and the UCITS Directive, already provide high standards for asset managers in Europe, and the AIFM Directive proposals introduce

[40] EFAMA is the representative association for the European investment management industry. Through its 26 member associations and 42 corporate members, it represents about €12 trillion in assets under management, of which approximately €7 trillion was managed by around 52,000 investment funds at end December 2009.

burdensome regulatory overlaps. This is the case in particular for many AIFs currently regulated at national level (mostly retail funds). EFAMA also fears the EC is introducing new rules which will later affect already highly regulated funds, such as UCITS.

The **European Private Equity and Venture Capital Association** (EVCA) has stressed the positive role of PE through the sponsorship of a number of studies and position papers. It maintains that PE is a valuable source of capital for companies and a driver for competitiveness through innovation and productivity improvements and the improvement of management, including in the area of human resources. Furthermore, PE adapts to the institutions of the countries in which it invests; thus, as a rule, industrial relations systems are respected. Trade union and other claims that PE leads to a widespread deterioration of employment conditions and adversarial industrial relations are thus overblown.

EVCA is highly critical of the proposed Directive and has published a number of papers focusing on specific aspects. One major criticism of the Directive is that the proposed corporate governance provisions would apply only to AIFs; thus a discriminatory situation would arise relative to other types of owners. A second criticism focuses on the proposal to impose a cap on the amount of leverage that PE funds can use in financing transactions. A third criticism focuses on the proposal to mandate a minimum holding or lock-in period during which PE investments cannot be exited. Finally, the third-country provisions are anti-competitive and transparency requirements are also in need of modification.

The **Alternative Investment Management Association** (AIMA) represents the HF industry.[41] The association points out that 50,000 people are directly and indirectly employed in HFs in Europe, about 80% in the UK.

Until a few years ago the main investors in HFs were high-wealth individuals. More recently, around 60% of investors in HFs are institutions (pension, insurance, trust and endowment funds). Such institutions invest in HFs because they can obtain better risk-adjusted returns and this has significant social consequences, e.g. it gives support to pension funds.

AIMA contends that any effect of HFs on labour and employment matters would be found in the activist fund sector of the HF industry, which represents a very small percentage of HFs and assets under management. Additionally, this is declining because activism is time-consuming and difficult. However, there might be some possible indirect effect where HFs pursue event-driven strategies and might intervene to take advantage of something like a takeover bid. Short-selling strategies lead to price discovery and bring liquidity to the market. This can have positive effects; for example, Enron's flaws were revealed by short-sellers. Through these activities, HFs can indirectly help to create employment.

Moreover, HFs are not as big as is often thought. They manage USD 1.5 trillion, which is about 2% of assets managed globally. At any one point in time, HFs usually represent only about 1% of trading. Their main aim is the preservation of capital and indeed, as their name suggests, they seek to avoid risk by hedging. The leverage which they employ is also small, about one to two times assets, much less than banks, which are often 30 or 40 times assets. HFs are not big enough to pose a systemic risk. Indeed, many individual banks and SWFs are bigger than the whole of the HF industry.

[41] It was founded in 1990 to represent the global HF industry and has 1,100 corporate members (some 5,000 individual contacts) worldwide. The MFA is the domestic US trade body, although AIMA has many members in the US.

Overall, AIMA favours more transparency and supports those parts of the AIFM Directive relating to the registration of HF managers and the reporting by those managers of systemically relevant data to the authorities. The main concerns are with leverage controls and the possible protectionist consequences of the Directive. Much of the UK industry follows the voluntary 'Sound practices' as outlined by the industry's Hedge Funds Standards Board. At present, work is underway to produce international standards.

In an effort to defuse some of the criticisms of SWFs, an International Working Group on Sovereign Wealth Funds was established in 2008 at a meeting of SWFs hosted by the International Monetary Fund. Later this group launched a voluntary code of conduct, Sovereign wealth funds: Generally accepted principles and practices, generally referred to as the Santiago Principles. More recently, the group has evolved into the International Forum of Sovereign Wealth Funds (IFSWF).

# Conclusions

Drawing on an extensive literature review, the country sections in this report and the 24 company case studies in the attachment to the report, it is possible to offer a number of conclusions on the restructuring activity of investment funds overall as well as labour outcomes due to this activity. The first is that these funds have become important actors in Europe, albeit with significant differences between the different types of investment funds as well as, to a lesser degree, between funds within each type. PE tends to be associated with the highest degree of restructuring activity due to its typical acquisition of a majority stake and its objective of gains over the medium-term (ca. five years), based at least in part on operational efficiencies. SWF investments tend to be associated with the lowest level of restructuring due to a longer-term approach to investment and, possibly, because of the desire to avoid public controversy. In between are activist HFs, which generally only acquire minority stakes and attempt to implement relatively simple changes (e.g. replacement of management or divestment of certain activities) within a relatively short time period (ca. 12 to 18 months). In many cases PE and HFs acquired underperforming companies and then embarked upon a process of extensive restructuring with a view to enhancing performance. To date, the SWF has been less energetic but it has nevertheless started to restructure some of the operations of its acquisitions.

The second conclusion is that the labour outcomes as a result of investment fund activity vary widely from case to case due to the potential of both positive and negative impacts on labour as well as the differences in the strategies pursued by the different funds. PE and HF investment often leads to turbulence in employment and job transfers. In the long term, it is still difficult to say whether PE has a net negative effect on employment. In the case of HFs and SWFs, there are also job transfers and there may also be employment reductions, but this is more difficult to gauge given the lack of hard evidence. Overall, the balance of evidence suggests that PE has had more of an effect on firms and their employees. Although activist HFs overall tend to have less effect, in some cases successful HF activism can trigger major changes. In the case of SWFs, minority investment and passive ownership has had the least effect, but where a SWF acquires a large block of shares or acquires a firm outright this has the potential to have a major effect on corporate strategy.

In terms of work organisation, the overall picture from the case studies is one of little change. Working practices have mainly remained unchanged, though there has been an emphasis on securing improvements in efficiency in all cases. However, this does not seem to have been abnormal. Existing levels of training have been maintained, and even somewhat increased, after the intervention of the investment funds. There is some evidence of greater use of high-performance work practices in one of the cases, and this is consistent with some earlier survey-based studies (Bacon et al, 2004; Bruining et al, 2005).

In the case of industrial relations, again the main picture from the case studies is one of little change. At the stage when a fund intervenes or acquires a company, there is variation across countries as to whether employees are informed and consulted, but in most cases this is unlikely to happen. On the other hand, the advent of a fund does not seem to have negative effects on union recognition and membership and the dealings between funds and their workforces has been cooperative overall. However, there are exceptions to this across and within countries. Consistent with recent survey evidence (Bacon et al, 2010a) it should be noted that there was little or no involvement of employees and their representatives at the time of the acquisition. Post-acquisition, where there are statutory and customary rights to information, consultation and co-determination, these would seem to have been respected. In many cases employee representatives have been involved in restructuring decisions to the extent that existing regulation and company traditions allow.

The third broad conclusion is that regulation and institutions matter as mediators of investment fund activities on labour outcomes. Financial markets have affected the differential growth of funds and the varying levels of activity of investment funds in different countries. Activist HFs, for example, are hardly a factor in the Central European countries examined. More central to this study, labour regulation matters. It does not deter funds from intervening in a firm and is not inconsistent with corporate restructuring. However, labour regulation, especially the institutions of the labour market, does give employees a voice and does affect outcomes in ways favourable to employees. The cases provide general interesting data in relation to the role of national regulation, especially as a draft directive on alternative investment fund management is currently under consideration within EU institutions. One of the core proposals in this directive is that funds managing investments above a certain threshold should disclose more information about structure, strategy and investors. The role of regulation in influencing fund behaviour and outcomes has recently surfaced in the academic literature, both in terms of how it influences the selection of investee firms and what happens to these firms and their employees, but the evidence so far is embryonic.

The evidence on the role of national regulation is mixed. It is clear from the cases that variations in employment protection regulation do not inhibit fund-acquired companies from undertaking large-scale restructuring. This contrasts with the recent suggestion that new investment funds may target healthy companies not requiring restructuring in contexts where employment protection is strong. However, national regulations affecting employee voice and worker representation do appear to affect the extent to which employee representatives are informed and consulted in post-acquisition restructuring, if not during the acquisition itself. In this respect the results are consistent with a recent survey of company managers that shows that their firms follow existing national regulations and company practices on worker voice after acquisition by PE funds (Bacon et al, 2010b).

The financial and economic crisis since 2007 has had an effect on the number and value of fund interventions and acquisitions. As yet, it is unclear whether firms which are owned by funds will have fared better or worse in the crisis. It is still too early to draw conclusions on this matter. Already, however, there are some signs that funds may be expanding.

Overall, the study evidence is supportive of the nuanced view of new investment funds which is coming to the fore in the literature. These funds are neither ‘angels nor demons’ in terms of the impacts on labour in their invested firms (Lutz and Achleitner, 2009). While in most cases the funds are committed to growing the business, with restructuring seen as laying the foundations for this, the activities of these funds can create uncertainties over job transfers, possible future sales and divestments.

## Implications for further research

As this report has indicated, there are still major gaps in our knowledge and future research would be useful in several areas. Overall, it would be useful to have more publicly available cross-national data, especially statistical data, on these types of owners and on the companies they invest in. It would be useful if large-scale surveys of companies provided more information on ownership form so that statistical work could be performed. Survey information covering the views of both managers and employees and their representatives on employment and labour outcomes would also be useful.

Second, it is desirable to adopt a sufficiently long time period for a proper evaluation and to compare fund cases with appropriate non-fund cases. There is therefore a case for a longitudinal study of funds and their operation.

Third, on PE in particular, there are a number of areas where further research would be useful. For example, it would be interesting to explore origin-country effects. Thus, do US, UK and other funds differ in how they work and do they work differently in different countries? Additionally, it might be interesting to focus on differences between the size and financing structure of deals, for example deals of over €1 billion (so-called mega buyouts) and deals with higher leverage, to see whether these differ from smaller and more conservatively financed deals in terms of outcomes. Finally, one area that merits further investigation is the question of what happens to wage structures within PE-owned firms. The cases discussed in this report have shown that in some instances wage systems change, with probably more performance- and share-based pay, but it is not known what happens to wage relativities within firms.

On equity HFs, this report has focused on activism. It would be useful to have more examples of event-driven situations and especially to have more information on how and whether shorting per se may affect firms and hence labour outcomes. On HFs, it would also be useful to bring together the studies discussed in this report and in other reports for a more focused analysis. In addition, for HFs, it would be useful to explore the private databases of activist HF interventions, such as exist in the US and are being assembled in Europe, and to see whether, when put together with employment data, these can yield any more general conclusions.

On SWFs, similarly, it would be interesting to collect more case studies and to monitor their activities, in particular to see whether they are moving in a more activist and a more specialist direction. Here too it would be useful to know more about the implementation of the Santiago Principles on information disclosure, especially as it might affect employees.

There are two final areas where more research might have important policy uses. In terms of information and consultation, this report has shown that there are significant differences across countries as to what happens when funds intervene. There are differential implementation practices of EU directives across the EU and questions about whether there are differences between fund interventions/acquisitions and more general M&A situations. It is notable here that if the relevant clauses in the AIFM Directive go through, for the first time ever in EU law there will be an obligation, not on employers, but on shareholders to provide information to employees.

In terms of the specialist, but important, area of pensions, this report unfortunately has had little to say, except that with the possible exception of the UK, at first sight fund activity seems to have little effect on company pension schemes. Nevertheless, it would be useful to explore this in more detail in some relevant countries and also across more countries.

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*Though small in comparison with other institutional investors, investment funds have significant direct influence on companies. This has lead to heated debates regarding their impact on restructuring practices, employment levels and industrial relations at the firms they invest in. This report examines whether investment funds – in particular, private equity, hedge funds and sovereign wealth funds – help to revive underperforming companies and thereby contribute to employment growth or whether, on the contrary, they strive to maximise financial returns at the expense of labour. Overall, the report concludes that investment funds are neither wholly 'bad' nor wholly 'good' with regard to the impact on labour in their invested firms. However, for a more in-depth evaluation, longitudinal data comparing fund cases with appropriate non-fund cases is required.*

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