

**SPECIAL
REPORT**

LEVERAGED BUYOUTS, PRIVATE EQUITY AND RESTRUCTURING IN THE METAL SECTOR

Text / Ron Blum



Already challenged by restructuring in an increasingly global market, metalworkers and trade unions face additional problems when private equity firms use leveraged buyouts to make quick and excessive profits, often at the expense of workers. →



The Blackstone Group is one of the world's largest private equity firms and a market leader in transferring companies from public to private ownership.

Photo: AP



Just two years after Motorola spun-off its fifty year-old microelectronics business into a publicly traded company, Freescale Semiconductors was taken private in the largest ever leveraged buyout in the electronics industry. It was among the biggest deals by private equity firms at the height of the recent buyout boom. A consortium of private equity outfits including Blackstone, Carlyle, Permira and TPG paid US\$17.6 billion for the U.S.-based chip maker, outbidding another private equity consortium that had earlier acquired the semiconductor business of Royal Philips Electronics. Among those that gained from the Freescale deal was its CEO, who pocketed US\$50 million on the buyout.

Freescale, the leading supplier of semiconductors to the automotive industry, and a maker of computer chips for mobile phones and telecom equipment, ended up burdened with US\$9.5 billion in debt to finance the leveraged buyout and interest payments of more than US\$700 million a year. At the time of the deal, Forbes Magazine signalled its approval noting that, "chip companies' cash piles are particularly attractive to private equity. It can help buyout firms pay off the debt that they take on to buy the company."

Soon after the deal was completed in late 2006, Freescale management announced the lay-offs of 700 skilled workers. Then in mid-2008, the company claimed that not having found a buyer for the East Kilbride plant in Scotland, it would close the facility threatening another 900 skilled jobs. In fighting to protect the interest of East Kilbride workers, the UK trade union Unite said it faced a "veil of secrecy" from Freescale's private equity owners, with management acting to keep the union outside of formal consultations. Meanwhile, the company had moved to cut redundancy entitlements by 30 per cent months before plans for the plant became known.

Freescale workers at operations in the UK, U.S., France and Japan continue to face restructuring challenges compounded by the high debt burden resulting from the excessively leveraged acquisition. In a research and development intensive industry, the owners have nevertheless cut investment spending while a substantial share of the company's cash flow continues to service the accumulated debt.

The events at Freescale highlight the types of challenges that workers often face in leveraged buyouts. Chief among them are the restructuring consequences of excessive debt, private equity owners' attempts to sidestep accountability as employers and a lack of transparency. Given the typically shorter-term investment horizons of most buyouts firms, what the unfolding Freescale situation does not reveal is how and when the private equity portfolio companies involved may plan to exit the business. This is characteristically the last step of the leveraged buyout business model. These kinds of challenges present workers with significant risks and uncertainties that need to be addressed.

In response, metalworkers and their unions have developed and are increasingly utilising strategies to counteract the potential excesses of leveraged buyouts and to protect the interests of workers and their communities. Collective bargaining and organising are central, together with mobilising workers and cooperating with trade union organisations and social allies nationally and internationally in the fight for regulations that safeguard public interest, support quality employment and generate productive, long-term investment and skills development.

RESTRUCTURING AND CYCLES OF LEVERAGED BUYOUTS

Mergers, acquisitions, changing ownership and management control have long confronted workers and trade unions. Such challenges go back to the times when capital was forming the transnational companies that dominate today's metalworking industries. The impacts of leveraged buyouts on restructuring are relatively more recent, having taken shape since the late 1970s.

Two significant cyclical periods of leveraged buyouts have occurred. The first one, confined mostly to North America, peaked and then bottomed out in the 1980s. The second cycle, global in scope, began and accelerated at the start of this decade. It peaked in 2006-07 with deals totalling US\$1.4 trillion, which alone accounted for one-third of the value of all buyouts ever done, adjusting for inflation, according to Dealogic. In late 2007, the cycle topped out as signs of the current global financial crisis surfaced.

Between these two periods, leveraged buyout firms adopted a more benign sounding and now familiar name "private equity", yet the nature and risks of the business model remains unchanged; that is, attempts to use high leverage and debt, restructuring strategies and short investment periods in pursuit of excessive returns on equity.

Though the unfolding global financial crisis has reduced the size and number of deals, they continue to take place. Investment banks with balance sheets weakened by the unwinding of past leveraged financial instruments have at least temporarily frozen lending to fund higher-risk leveraged buyout strategies. Leveraged buyout firms are thus seeking other sources of capital such as sovereign wealth funds, which in turn, can minimise their disclosure and transparency by using private equity firms as conduits for buyouts.

In metalworking, leveraged buyouts have appeared in nearly all facets of restructuring, from acquisitions or divestitures related to enterprise restructuring; to situations of "distressed assets", bankruptcy claims and consolidation of operations associated with industry consolidation; and to situations where privately-held, family-controlled enterprises face issues of succession.

What the unconstrained leveraged buyout model introduces into the restructuring mix is a high risk combination of leveraged debt financing with a short-term intent to resell the business in order to extract extraordinary returns. Without protections negotiated by trade unions through collective bargaining, excessive returns under this model can come at the expense of good jobs, secure pension plans, needed investments in operations and product development, and the upskilling and training of workers.

LEVERAGED BUYOUTS, DEBT AND CASH FLOW

The degree of leveraged financing is reflected in a commonly used financial measure, the leverage ratio. This ratio compares the borrower's total debt from all sources to cash flow, which is typically calculated as earnings before interest, taxes, depreciation and amortization (EBITDA). Among the "Lords of Leverage" in the private equity industry, leverage ratios prior to the unfolding credit crisis indicate the degree of debt involved in typical private equity acquisitions.

| Private Equity Firm | Leverage Ratio |
|----------------------------|----------------|
| Madison Dearborn Partners | 11.8 |
| Providence Equity Partners | 11.0 |
| Blackstone Group | 10.6 |
| Thomas H. Lee Partners | 10.3 |
| Carlyle Group | 9.6 |
| Goldman Sachs Group | 9.5 |
| Apollo Management | 9.1 |
| TPG | 8.2 |
| Bain Capital | 7.8 |
| Kohlberg Kravis Roberts | 7.5 |

The data above shows the average amount of debt committed to an acquisition relative to the target's EBITDA. It includes announced U.S. acquisitions of more than US\$100 million from January 1, 2005, to September 12, 2007, for which merger agreements were available.

Source: "Madison Dearborn Beats Blackstone, Goldman Sachs as Deals Stall", Jason Kelly, Bloomberg, October 1, 2007

PROTECTING METALWORKERS THROUGH COLLECTIVE BARGAINING

The use of leveraged buyouts in metalworking during the last several decades has taken place in a broader context of industrial restructuring within and across borders. Outsourcing, subcontracting, the substitution of temporary for permanent jobs, consolidation of operations and supply chain restructuring have exacted heavy

tolls on workers and their communities. In many cases, consequences have been made worse when investors in pursuit of extracting quick and inordinate profits use highly leveraged buyouts to drive the restructuring process at the expense of workers.

Affiliates of the International Metalworkers' Federation (IMF) have developed and increasingly use counter-strategies through collective bargaining to defend employment and working conditions, maintain pensions and secure investments, and to influence conditions of potential leveraged buyouts. These approaches have evolved over time as trade unions carefully account for institutional, legal and industry factors in order to enhance their effectiveness.

The following examples illustrate important aspects of these approaches used in a range of circumstances in the automotive, aerospace and mechanical engineering industries.

- Unite in the UK set out concrete demands upon which the sale by Ford of Jaguar and Land Rover would need to be conditioned, impacting the decision of the eventual buyer among which were auto assembler companies and some private equity interests. Among the range of important guarantees achieved in the conditions of sale to Tata Motors in 2008, was the continuation of existing arrangements for trade union recognition and bargaining, protection of workforce terms and conditions of employment including current pension arrangements, and long-term production, development, investment and sourcing commitments from Ford and Tata.
- With the acquisition by Cerberus of Chrysler in 2007, in which Daimler retained a 20 per cent stake, the United Auto Workers (UAW), Canadian Auto Workers (CAW) along with IG Metall insisted that the new ownership and company structure contribute to a safe and sustainable future for the Chrysler Group. Industry and company level collective bargaining by the UAW and CAW have ensured continuity of negotiated protections of workforce terms and conditions of employment including pension and healthcare provisions.
- After Dana filed for bankruptcy in the U.S. in 2006, the company tried to cancel labour contracts and the UAW and United Steel Workers (USW) together made it clear that such drastic action could result in a labour dispute.



Global union conference on private equity held in Nyon, Switzerland in November 2006.

Photo: UNI

The high-stakes bargaining led to a successful outcome, which included involvement by Centerbridge, a private equity investor. The company agreed to limit how much debt the company could take on; to regular meetings and reports regarding finances; and, to expand the rights of unorganised Dana workers, the unions insisted on fair procedures, including card-check recognition, a process where employers agree to recognise a union once a majority of workers indicate their preference by signing union authorisation cards.

- When Linde in Germany planned to spin-off its KION division after acquiring BOC in 2006, IG Metall and the works council prepared for a possible leveraged buyout. An established process required that all preferred bidders give presentations on their strategy and future investment plans to the works council and union. KKR and Goldman Sachs won an accelerated auction against three other private equity bidders. The new owners agreed to honour previously negotiated employment guarantees, use finance with a high share of equity capital, commit to future investments, and wait to bring KION to the stock market between 2010 and 2012.
- Commercial aircraft facilities spun off from Boeing in 2004 formed Spirit AeroSystems. The International Association of Machinists (IAM) and UAW negotiated the Union Equity Program, whereby workers were given share holdings that would provide them benefits from future growth, and rehire and recall provisions to cover nearly all fellow union members. When the company was brought to the market, the value of the shares for workers more than made up for the prior wage concessions, generating an average of US\$ 61,000 per worker through early 2007.

From the outset of any considered form of restructuring, it is essential that companies fully inform, consult and negotiate with unions and worker representatives of all potentially affected operations on the nature and possible impacts of restructuring with complete consideration of alternatives. In any acquisition or takeover situation, obtaining concrete information about proposed strategic plans of prospective buyers is critical. Given the nature of leveraged buyouts, it is particularly important to ascertain information on the degree of leverage, the structure of financing, and the length of time and investments that the prospective private equity owners commit to the business.

REGULATION IN THE PUBLIC INTEREST

The unconstrained leveraged buyout business model has both evolved from and fed a broader process of increased financialisation of corporate behaviour and economic activity. Impacts of deregulation, privatisation and market fundamentalist policies have become all too clear in the unfolding global financial crisis. The crisis demonstrates as well that the use of excessive debt and leverage to amplify returns to capital reaches well beyond the confines of leveraged buyouts.

THE NATURE OF THE UNCONSTRAINED LEVERAGED BUYOUT MODEL

The strategic plan behind a leveraged buyout that aims at very high targeted rates of return on investment and rapid exit typically starts with high debt relative to equity to acquire the assets. It then incorporates a mixture of methods to extract the originally invested capital plus profits.

Such methods can range from quick asset disposals used to immediately reduce some of the debt incurred in the acquisition to targeting workers' pension and benefit funds. Such a plan could also aim to intensify cost-cutting pressures, consolidate operations, and scale back investments needed to maintain and grow the business, while taking advantage of the tax-deductibility of interest payments on the debt.

The extraction of the initially invested capital, accumulated equity and profits is typically accomplished by a combination of means. High management fees paid by the portfolio company to the private equity owners is one method. Another is through large cash dividend payments financed by additional debt, referred to as a dividend recapitalization or "recap", which can keep leverage high up to the time of exiting the business. Finally, a full or partial public offering of stock, or a second or even third leveraged buyout can be the vehicle to sell the business and assets at the last stage of this kind of model.

A leveraged buyout differs fundamentally from a traditional merger or acquisition in two important ways. First, the acquired company pays the cost of its own acquisition through debt and fees. Secondly, the private equity firm has to surpass a "hurdle rate" that has been agreed to with investors before it can collect "carried interest", which is the profit made when the acquired company is sold. This means that a private equity investor is necessarily aggressive in pursuit of such profits.

These two elements are central to the leveraged buyout process and pose particular challenges to unions when engaging and bargaining collectively with private equity portfolio companies. Generally, the potentially adverse restructuring impacts of leverage buyouts on workers tend to increase the higher the targeted return on investment, the more leveraged the deal, the faster the withdrawal of equity and the shorter the period before exiting the investment.

Sources and further information:

"Leveraged Buyouts, Restructuring and Collective Bargaining" by Ron Blum and Peter Rossman, *The International Journal of Labour Research*, vol. 1, issue no. 2, forthcoming (December 2008)

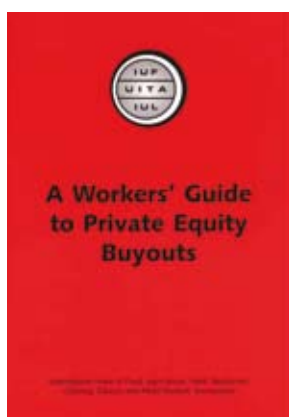
"A Worker's Guide to Private Equity Buyouts", available at the IUF's Private Equity Buyout Watch, <http://www.iuf.org/buyoutwatch/>

When it comes to leveraged buyouts, the accountability of private equity portfolio firms as employers, owners, and investors needs to be addressed through changes in rules governing financial markets, corporate taxation and pension fund investments. What is needed are rules and regulations to promote productive investment based on



"A Workers' Guide to Private Equity Buyouts", published by the International Union of Food and Agricultural Workers (IUF), can be found at:

www.iuf.org/buyoutwatch



the long-term interests of working people, including long-term employment security and good jobs, and the full and effective protection of worker and trade union rights.

Public attention has increasingly focused on two issues of corporate taxation: the treatment of “carried interest” and the tax-deductibility of interest paid on leveraged buyout-related debt. When a company acquired through a leveraged buyout is sold, the private equity fund manager gets a percentage of profit, usually around 20 per cent. This is called “carried interest”. Rather than being taxed as “capital gains”, fund managers pay far lower taxes by having the gains they pocket on the sale treated as regular income.

Greater in effect is the tax deductibility of interest on leveraged buyout-related debt. While all businesses benefit from the tax deductibility of borrowed money, the benefits to buyout firms are amplified as the leverage they use increases. Not only does tax deductibility apply to interest on debt borrowed to fund the leveraged buyout acquisition, it also applies to debt incurred to finance so-called “dividend recapitalizations” that serve to extract built-up equity in the company.

As a result of such rules favoured by buyout firms, public treasuries are thereby deprived of resources needed to fund education, health care and pensions. It shows how financialisation comes at the expense of the interests of working people, and why rules and regulations in the public interest are instrumental to counteract these effects.

THE ONGOING CHALLENGE OF BUYOUTS

Given the cyclical nature of the buyout business, unless much needed changes are achieved, highly leveraged financing to acquire and manage companies for quick returns will continue to challenge workers. IMF affiliates are grappling with the collective bargaining challenges of that business model while mobilising to fight against the deregulation of capital markets sought by private equity firms, hedge funds and other financial interests. Re-regulation is required to promote productive long-term investment, employment security and the creation of good jobs.

Across sectors and internationally, the IMF continues to support advancing these responses through cooperation with other Global Union Federations. These have included joint efforts and activities with the International Union of Food workers (IUF) and Union Network International (UNI), as well as cooperation with Trade Union Advisory Committee (TUAC) to the Organisation for Economic Co-operation and Development (OECD) and the International Trade Union Confederation (ITUC).

As workers at Freescale and many other companies across the metal sector have experienced, the financial mechanisms at the core of the leveraged buyout business model adds significant pressures on workers and trade unions. This is over and above the pressures of ongoing restructuring that have become a constant feature of today’s global and financialised economy. Regardless of the form of restructuring, it is essential that unions continue to mobilise to ensure socially acceptable outcomes through collective bargaining, organising and achieving social and economic protections for all workers.



GIUSEPPE FARINA

Giuseppe Farina, was elected General Secretary of the IMF Italian affiliate FIM-CISL in June 2008.

He was first employed in a small metalworking company, where he joined the union and began university studies in sociology. Later he became a fulltime unionist, first at FIM-CISL in Lathium and then at FIM in Rome at the provincial level.

From 1990 to 1999 working in the national federation, Giuseppe was responsible for members in large companies such as Finmeccanica, Fincantieri and Nuovo Pignone.

In 1999, he was elected to the National Secretariat of FIM and was responsible for trade union policies. In 2004, Farina assumed the responsibility for organizing policies and achieved positive results both in administration and in the growth of the organization. Giuseppe is married and has two children.



TAHER BERBERI

In 2007, Taher Berberi was elected General Secretary of IMF Tunisian affiliate the Metal and Electronic Workers’ Federation and in 2008 became a member of the IMF Executive Committee representing North Africa.

Taher, 46, first joined the union in 1992 following a conflict with his employer. At the time Taher had no idea that in the year 2000 his comrades would elect him general secretary of the local union at the steel plant.

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It was a difficult time at the enterprise, which included delays in payments to workers, a decision to stop a blast furnace covering 70 per cent of production and early retirement of 1,000 workers, all with the aim of privatizing the enterprise.

Taher and his colleagues did not give up. Following a series of strikes the Ministry of Economy signed an agreement stabilizing the situation at the enterprise.



RIKU AALTO

Riku Aalto, 43, was elected President of the Finnish Metalworkers’ Union at its 20th Congress in May in Tampere, Finland. Aalto replaces the former President of eight years, Erkki Vuorenmaa. The union will celebrate its 110th anniversary next year.

Aalto has been a member of the Metalworkers’ Union for the past 25 years. He joined the union at the age of 18 after starting work at the Saab-Valmet car factory in Uusikaupunki in 1983. During this time he was elected shop steward of his unit.

He came to the Metalworkers’ Union as a staff member in 1995 holding different positions. Before he was elected President, he was Head of Finance of the union.

Aalto holds a Master’s Degree in Administrative Science from the University of Tampere.