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Summary of case studies on Private Equity Funds and Hedge Funds and conclusions of Rasmussen expert group 2007[1]

1. Introduction

In Europe until 2000, private equity companies and hedge funds – often together described as "alternative investments" – were at best significant only in the UK and Ireland, as well as in the smaller states of Luxembourg and Liechtenstein. However, since then the situation has changed rapidly. Other European governments have shown themselves open to the idea that alternative investments can have a positive influence on the economy and can provide badly needed capital. States have improved the structural conditions for alternative investments, removing regulations and restrictions and offering investors tax concessions.[2] It now seems simply a matter of time before hedge funds and private equity funds can act as freely in Europe as they can in the USA.

In 2006, the funds carried out around 2,000 transactions worth more than €500 billion in total – in the process dominating the takeover market.[3] The value of European buyouts reached €168 billion – 42% more than in 2005. The investors have now looked closely at what Europe offers and have found attractive prospects among the German "Mittelstand" – small and middle-sized companies in the areas of machine tools, automotive components and elsewhere. In contrast to many large companies, the German Mittelstand is not driven by the goals of shareholder-value. These are firms that are satisfied with smaller returns and have a longer-term perspective. They are often family-owned, identifying themselves with a specific business, and they feel a sense of responsibility towards their employees. Frequently they have large reserves, both open and hidden in their accounts, substantial levels of equity capital and good cash flows. Some of them are conglomerates. A number of leading Mittelstand companies are worldwide leaders in their fields, producing outstanding products for a specific market niche. However, there are often inefficiencies in the way these companies are organised, whose removal could boost returns. All these elements make the companies of interest to private equity companies and their return-hungry investors.

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[1] **The following treatise is published as a contribution in Danish language headed *Kapitalfonde i praksis* in: Poul Nyrup Rasmussen [ed.], I Grådighedens Tid, Kapitalfonde og Kasinoøkonomi, København 2007. A copy of the article in German language is available at www.finmarktreg.de. The article was produced in the context of an expert group headed by Poul Nyrup Rasmussen in 2007. Rasmussen was at this time president of The Party of European Socialists (PES). Formerly he was Danish Prime Minister. The expert group aimed to influence the European regulation of Alternative Investments starting in 2007 (later AIFM Regulation), i.e. the regulation of Private Equity Funds, Hedge Funds and some Investment Funds.**

[2] The Economist 17. 2 2007, p. 74-75

[3] Handelsblatt 29.12.06, p. 25

Additionally, the area of operations for alternative investors has been increasingly extended to large European companies. The number of mega-deals – those with a value of more than one billion euros – increased by 28% to 36 between 2005 and 2006, and their overall value doubled in the same year.[4] It is also noticeable that private equity and hedge fund companies have become increasing aggressive in their approaches to companies. Hostile takeovers, which a few years ago were practically taboo for the private equity industry, are now part of their armoury.[5]

A number of companies have gained in competitiveness and taken on new employees as a result of private equity involvement. Private equity companies have rescued insolvent or failing companies, which had found no other buyer. Extremely high targeted rates of return played a role in all of these cases.

However, alongside these positive examples, there are a large number of critical cases. And by critical, what is meant is that investors load companies with debt, strip out their assets, get rid of large numbers of employees, cut wages or worsen working conditions or the atmosphere in the business and – where hedge funds are involved – interfere massively with the long-term strategy of the company on the basis of short-term interests.

The following sections work through the typical problem areas of alternative investment on the bases of case studies from both the private equity and hedge fund industries[6], and deals with some questions as to how they should be regulated.

2. Typical case studies of the activities of private equity funds

The involvement of private equity investors in the German TV company *ProSiebenSat1* was positive. A group of investors around Haim Saban rescued the company and its jobs from bankruptcy. The previous owner's management failures had led to the crisis.[7] *Wincor Nixdorf*, making cash dispensers for banks, checkout systems and packaging machines, led a shadow existence in the Siemens group. The private equity company KKR developed it into a competitive business, and positive trends in its markets made a substantial contribution to making the process a success.[8] Similarly the aircraft maker *MTU Aero Engines* had little priority in its former group Daimler. After its sale to KKR it was able to concentrate on its business.[9] In another example, the Swedish investment company EQT bought two

[4] Börsenzeitung 23.01.07, p. 12

[5] For example, at the end of 2006, the private equity company CVC got its investors to approve the possibility of it taking part in hostile takeovers; Börsenzeitung 04.01.07, p. 10

[6] The author is able to rely on a database in the Hans Böckler Foundation evaluating 160 cases of hedge fund and private equity involvement.

[7] Frankfurter Allgemeine Zeitung 06.08.03, p. 1, Süddeutsche Zeitung 06.08.03, p. 1, Financial Times Deutschland 06.08.03, p. 1, p. 6, p. 24; Handelsblatt 06.08.03, p. 1; Financial Times Deutschland 13.08.03, p. 5; Frankfurter Allgemeine Zeitung 13.08.03, p. 10; Frankfurter Allgemeine Zeitung 07.09.04, p. 11

[8] Wirtschaftswoche 02.09.04, p. 78; Frankfurter Allgemeine Zeitung 02.05.05, p. 13; Börsen-Zeitung 18.05.05, p. 11

[9] Wirtschaftswoche 02.09.04, p. 78; managermagazin 5/05, p. 119 f.; Frankfurter Allgemeine Zeitung 03.05.05, p. 16; Handelsblatt 10.05.05, p. 1, p. 29; Frankfurter Allgemeine Zeitung 11.05.05, p. 16;

German fragrance and flavourings manufacturers in 2003: the family company Dragoco as well as Haarmann & Reimer, a Bayer AG subsidiary. The buyer merged the two into a new company, Symrise, and pushed it to fourth place in the world rankings. It was floated on the stock market in October 2006 and in 2007 it moved up into the MDAX – the section of the German exchange for mid-sized companies.[10] In another case, KKR improved the growth path of the German car repair chain *A.T.U. – Autoteile Unger*: the number of repair shops increased by around 10% during the period of its involvement. However, as the workforce levels remained unchanged, this meant harder working conditions for the employees and an increase in working time from 37.5 to 40 hours a week.[11] KKR has published almost no information about 2006; both sales and profits have fallen. *Linde* was a conglomerate with four business areas and was often regarded as a candidate for takeover. It sold its forklift truck business ("Kion") to KKR and to Goldman Sachs. The investors and CEO Wolfgang Reitzle were prepared to accede to the demands of the works council and the metalworking union (IG Metall) and to commit the company to honouring the previous investment plans and the guarantee that employment would be maintained, which both ran until 2011.[12] However, all of these examples, which are relatively positive in terms of the continued existence and job security of the companies concerned, have a critical side: in order to achieve high returns, the private equity companies took very a substantial amount of assets from the companies and – once they had pulled out – left them to their fate with a much weakened capital structure.

In contrast to these cases, which, despite some areas of criticism are broadly positive, there are a large number of negative ones. In the USA, the involvement of three investment companies in the car hire company *Hertz* made headlines. At the end of 2005, the funds bought the company from Ford for $15 billion, using $2.3 billion of their own money; $12.7 billion was financed through debt. A year later, at the end of 2006, they brought the company to the stock market and raised $1.32 billion for 28% of the shares (they held on to the rest). In the 11 months of their involvement they caused the company to make special payments, which were financed through credit, worth just under $1.5 billion. In addition they charged another $92 million for consultancy and other services. The debts bore down

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Handelsblatt 11.05.05, p. 21; Süddeutsche Zeitung 11.05.05, p. 22; Handelsblatt 25.05.05, p. 37; Handelsblatt 01.06.05, p. 35; Handelsblatt 03.06.05, p. 31; Süddeutsche Zeitung 04./05.06.05, p. 29; Handelsblatt 06.06.05, p. 21; Süddeutsche Zeitung 07.06.05, p. 23, p. 30; Süddeutsche Zeitung 07.09.05, p. 30; Börsenzeitung 09.11.05, p. 13; Börsenzeitung 01.02.06, p. 1, p. 3, p. 9; Financial Times Deutschland 01.02.06, p. 3; Financial Times Deutschland 24.03.06, p. 10; Süddeutsche Zeitung 03.05.06, p. 28; Süddeutsche Zeitung 13./14.05.06, p. 27; Handelsblatt 18.2007.06, p. 17; Börsenzeitung 27.2007.06, p. 8, p. 10; Handelsblatt 26.10.06, p. 17; Financial Times Deutschland 26.10.06, p. 11

[10] Wirtschaftswoche 28.04.2005, p. 66; Handelsblatt 30.05.2005, p. 26

[11] Finance 09/04, p. 28 f.; Wirtschaftswoche 02.09.04, p. 78; Börsenzeitung 14.10.04, p. 17; Frankfurter Allgemeine Zeitung 02.05.05, p. 13; Handelsblatt 06.05.05, p. 3

[12] Süddeutsche Zeitung 09.06.05, p. 24; Frankfurter Allgemeine Zeitung 29.06.05, p. 12; Börsenzeitung 05.09.06, p. 13; Frankfurter Allgemeine Zeitung 22.09.06, p. 17; managermagazin11/06, p. 91ff.; Börsenzeitung 01.11.06, p. 11; Börsenzeitung 07.11.06, p. 11; Financial Times Deutschland 17.11.06, p. 10; Financial Times 07.11.06, p. 13; Börsenzeitung 23.11.06, p. 9; Börsenzeitung 28.11.06, p. 9; Börsenzeitung 22.12.06, p. 10; Börsenzeitung 09.01.06, p. 9; Börsenzeitung 12.01.07, p. 9

enormously heavily on Hertz's profit performance[13]. In Europe, the case of the Danish telecommunications company, *TDC*, was equally spectacular. Five private equity funds bought the company for around €15 billion. After only a few months they allowed themselves an extremely high payment of around €5 billion from company resources. Taking account of the high proportion of external financing involved in the purchase, the funds had recovered the capital that they had put up in a very short period of time, yet they still owned the whole of company.[14] The American Texas Pacific Group (TPG) made itself notorious in Europe through three particularly bad examples. In *Gate Gourmet*, the second-largest airline caterer worldwide, TPG put in place a recovery plan with a very severe impact on employees, and the introduction of worsened working conditions provoked a large number of conflicts with the workforce. The investors' strategies did not work: their involvement was loss-making. In France, TPG employed an ex-CIA man to act for it in the chip-card maker *Gemplus*, which operates in some areas which have security implications; the appointment produced a storm of protest in the country. And in Germany, TPG is trying everything to get the mobile phone provider *Mobilcom* to pay out a gigantic special dividend, thereby hindering the company's economic development. The Federal Printing Press (Bundesdruckerei) in Germany, a previously state-owned company, has been virtually ruined by financial investors[15] and the motorway service station chain, Tank & Rast, has been bled dry by special dividends and now suffers from thin capital backing.[16] There have been major conflicts in the UK in 2006 and 2007 over the involvement of PE companies in the AA motoring organisation, the restaurant chain Little Chef, the supermarket group Sainsbury, the frozen food manufacturer Birds Eye and the car park provider NCP. Two cases in the UK and three in Germany will now be examined more closely.

Gate Gourmet was, before its takeover, a company within in the Swiss airline group Swissair. As a result of the turmoil that followed 9/11, the parent company and the subsidiary catering business, both of which operated in many countries, ran into difficulties. TPG bought the business in 2002. In 2005, it developed a recovery plan that provided for lower wages, the loss of social benefits, worse working conditions and the cutting of 675 out of 2,200 jobs. In a ballot the employees, who were organised in the T&G general union, rejected the recovery plan. In August 2005 the conflict escalated. Despite the planned job cuts, the company took on temporary agency staff. The employees held a meeting and asked for an explanation, upon which the company first locked them in and then issued an ultimatum requiring them to accept the new arrangements. When they refused, the whole shift was dismissed on the grounds that they were engaged in an unlawful strike. In total some 670 employees were sacked. The "Daily Mirror" newspaper subsequently revealed what the workforce had suspected, that – from the start – the aim of TPG had been to provoke a strike so as to have a pretext for the mass sackings. A subsidiary, Versa Logistics, had already been set up to replace the sacked workers with cheaper

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[13] Frankfurter Allgemeine Zeitung 08.12.06, Frankfurter Allgemeine Zeitung 17.11.06, p. 24

[14] Schneider 2006

[15] Wirtschaftswoche 02.09.04, p. 78; Süddeutsche Zeitung 03.05.05, p. 2; Wirtschaftswoche 19.05.05, p. 48; Manager-Magazin 10/05, p. 58-67; Süddeutsche Zeitung 04.01.07 p. 5

[16] Wirtschaftswoche 02.09.2004, p. 78; Financial Times Deutschland 26.07.06, p. 1; Frankfurter Allgemeine Zeitung 27.07.06, p. 15

Polish temporary staff. Polish workers were being played off against the Gate Gourmet employees, who overwhelmingly were migrants from Bangladesh, Pakistan and India. British Airways (BA) ground staff, who were also organised in the T&G, stopped work in solidarity against the mass dismissals at Gate Gourmet and brought international air traffic from London Heathrow to a standstill: 100,000 airline passengers could not take off. Many of Gate Gourmet's employees had previously worked for BA. The second largest trade union at Heathrow declared that its members would not act as strike breakers. On 29 September the staff who had been sacked by Gate Gourmet accepted a settlement: the majority of those dismissed could either return to the company or take a monetary pay-off. At Gate Gourmet's German operations, parallel to these developments in the UK, working hours were lengthened, holidays shortened and shift premia abolished. The pressure of work increased sharply, according to the members of the works council. The result in Germany was a strike that lasted 176 days in total and finally ended with a compromise: an increase in the working week from 38 to 40 hours and flexible working times, in return for free shifts and no compulsory redundancies until 2009.[17]

In 2004, the British motoring organisation the *Automobile Association (AA)* was sold by the Centrica Group, which had increased the number of members by 5.5 million to 13.2 million, to the PE companies CVC and Permira for £1.75 billion. Some £1.3 billion of the purchase price was financed through debt. Within three months unprofitable vehicle servicing centres had been closed and 1,300 staff dismissed. Other employees went in several further waves. The original 10,000-strong workforce was reduced to around 6,600 today, with around 500 patrol staff lost and the rest going from administration and call centres. The number of patrols was cut. Even the chief executive now accepts that the workforce was spread too thinly. The result was much heavier workload, with a massive increase in overtime leading to working days of up to 11.5 hours and working weeks of up to 90 hours. Rather than dealing with an average of 5.2 incidents a day, patrols now had to look after 6.8. The response time to breakdown calls from went up from 30 minutes to up to four hours, and the AA fell from first to third place in the league table produced by the consumer magazine "Which?". In parallel to the cuts in staff, membership subscriptions were increased by 30%. In the period between 2003 and 2005 the company's profits doubled to around £200 million. The level of debt at the start of 2007 stood at £1.3 billion. At the same time a special payment of £500 million was set to be made to the private equity funds, potentially taking debts to almost £1.9 billion. The chief executive Tim Parker has already received bonuses worth £20 million, and he would get a substantial additional bonus if the AA were to be brought to the stock market.[18]

The case of *Friedrich Grohe GmbH*, in which private equity funds were involved, caused a major uproar in Germany and led to massive criticism of the funds. The company was heavily loaded with debt by the funds, got into difficulties as a result and dismissed a large number of employees. At the same time the funds stripped the company of many of its assets. This led Franz Müntefering, chair of the German

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[17] Neue Rheinische Zeitung online, 25.01.06; homepage gategourmet.com, as at 26.02.06; FTD online as at 27.02.06; Berliner Zeitung online, 28.02.07

[18] Bloomberg News, 04.05.06; Brüssel IP/04/1049 27.04.04; homepage gmb.org.uk, 26.02.07, as at 12.03.07; Die Zeit 27.02.06; homepage gmb.org.uk, 26.02.07, as at 12.03.07; FTD online as at 27.02.06; Berliner Zeitung online, 28.02.07

social democratic party (SPD), to say that the investors were like locusts: they fed on a company and then moved on. Since then it has become impossible to envisage public debate without this startling image. What actually happened? The private equity company BC Partners bought Grohe in 1999 for €900 million, with two-thirds of the purchase being financed by bank loans. As a result of the fund's actions, the proportion of external capital in Grohe increased from 50% in the years before their involvement to 94% in 2003. BC Partners had around €350 million paid to themselves between 1999 and 2003 in the form of special payments ("dividend recapitalisation", or "recaps" for short). The company brought its investor profits of 20% every year. In 2004 BC Partners sold on the company in a "secondary sale" to the investors Texas Pacific Group (TPG) and Credit Suisse First Boston (CSFB) for €1.8 billion, a price experts thought was too high; the substantial assets hidden in the company's balance sheet had already been extracted by BC Partners. Because of the high level of debt, the company got into difficulties, and in a restructuring programme, developed by management consultants McKinsey, around 1,000 of the company's 5,000 employees were marked down for redundancy. Improved market conditions and foreign success resulted in an improved turnover and better operating results in terms of EBITDA (Earnings before interest, tax, depreciation and amortisation), leading to a small number of the redundancies being withdrawn. Because the Grohe case provoked a critical debate in Germany, the company's management, the investors and a group of academics – who were commissioned by the Federal government to produce an expert report as part of the preparations for new investment legislation – are now using these improvements to claim that it was the involvement of private equity shareholders which made the company more competitive. But the evidence for this is not there. The other side of the truth remains unspoken: that, without the high indebtedness caused by the private equity shareholders, the large-scale redundancies that took place would not have been necessary or would not have needed to be as substantial. Grohe is still making losses, the extent of which has not been made public and the company continues to be heavily in debt; the ratings agency Standard & Poor's has downgraded Grohe to junk bond level.[19]

The involvement of financial investors in the German motor components maker *Edscha AG* has similarly had a clear impact on the workforce. In 1997, the company was sold to Flint Echo and NatWest for €130 million. They passed the company on to the private equity company Carlyle in 2002 for €245 million in a secondary sale. In the following years Carlyle paid itself €60 million in credit-financed special dividends. But as the economy worsened, Edscha got into difficulties, and it had no reserves to absorb the losses. Some 1,000 jobs were cut, out of a total of 6,900.[20]

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[19] Wirtschaftswoche 02.09.04, p. 78; Frankfurter Rundschau 09.06.05, p. 9; Handelsblatt 09.06.05, p. 11; Der Spiegel 02.05.05, p. 134; Handelsblatt 06.05.05, p. 3; Süddeutsche Zeitung 07./08.05.05, p. 27; Handelsblatt 24.05.05, p.17; Frankfurter Allgemeine Zeitung 24.05.05, p. 18; Süddeutsche Zeitung 31.05.05, p. 28, Süddeutsche Zeitung 01.09.05, p. 30; Heinz Kussmaul/Armin Pfirmann/Vassil Tcherveniachki, Leveraged Buyout am Beispiel der Friedrich Grohe AG, in: Der Betrieb, Heft 47 / 2005, p. 2533-2540; Financial Times Deutschland 24.08.06, p. 3; Börsenzeitung 10.01.07, p. 13; Frankfurter Allgemeine Zeitung 10.01.07, p. 19; Frankfurter Allgemeine Zeitung net 15.01.07, Börsenzeitung 10.01.07, p. 13; Frankfurter Allgemeine Zeitung 12.02.07, p. 15; Frankfurter Allgemeine Zeitung 05.03.07, p. 16

[20] Süddeutsche Zeitung 17.11.05, p. 24; Financial Times Deutschland 07.04.06, p. 9; Süddeutsche Zeitung 04.10.06, p. 23; Handelsblatt 04.10.06, p. 21; Frankfurter Allgemeine Zeitung 04.10.06, p. 18;

Kiekert was another motor components company where the combination of high indebtedness, as a result of the involvement of the private equity fund Permira, and the sales problems which are typical of the industry resulted in a crisis which the company solved at the workforce's cost. Kiekert is a world leader in car door closing systems, which was bought by Permira in summer 2000 for €530 million – a purchase financed primary with external capital. In 2003 the company was de-listed from the stock exchange. The high burden of debt and a downturn in the business, brought about through high raw materials and energy prices and the loss of Ford as a major customer, meant that in 2005 Kiekert could not meet its credit obligations. In the autumn of 2005 the creditors began to sell Kiekert debt at a discount and the financing banks and the hedge funds, which by this stage had bought part of the company's bank loans, took it over in a debt-for-equity swap, forcing out the private equity funds. Permira lost a substantial portion of its own invested capital. The company now transferred large parts of its production from Germany to the Czech Republic, which alone cost 200 people their jobs. In order to make the savings in 2007-2008 the assembly lines, which were to remain running until 2009, were at short notice moved to the Czech Republic. In 2000, Kiekert employed around 4,000 staff. In 2006, a programme to preserve production in Germany until 2009 was agreed between the workforce and the employers. It provided for a further reduction from the, by this stage, 1,500 employees in Germany to 1,350, with the employees giving up their holiday bonus and the pay increase which the union had negotiated. In return compulsory redundancies were excluded – for the moment.[21]

The experience of private equity's involvement in the German motor components industry shows in an exemplary way how companies where private equity funds have been involved can – as a result of unfavourable developments in the market and high levels of debt, or sometimes low levels of equity capital – find themselves on the edge of the abyss, with jobs destroyed in consequence. As well as Kiekert and Edscha, the motor components makers Honsel and TMD Friction have had similarly negative experiences where private equity has been involved.[22]

3. Typical case studies of the activities of hedge funds

In 2006, the Swiss temporary staff company *Adecco* planned to take over the Düsseldorf temporary agency DIS, and acquired 83% of the company's shares in a number of stages. Two hedge funds, Elliott International and The Liverpool, intervened in the takeover and bought 10% and 3% of DIS respectively. The funds knew that Adecco wanted to increase its holding in DIS to over 95% and to force out the remaining shareholders in return for a cash payment – the "squeeze-out". Adecco announced that it wished to de-list DIS AG from the stock exchange and to cut the dividend by 80% compared to the previous year, effectively forcing the

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Süddeutsche Zeitung 05.10.06, p. 25; Börsenzeitung 31.10.06, p. 11; Süddeutsche Zeitung 31.10.06, p. 26; Frankfurter Allgemeine Zeitung 20.01.07, p. 14

[21] Süddeutsche Zeitung 17.11.05, p. 24; Financial Times Deutschland 07.04.06, p. 9; Süddeutsche Zeitung 04.10.06, p. 23; Handelsblatt 04.10.06, p. 21; Frankfurter Allgemeine Zeitung 04.10.06, p. 18; Süddeutsche Zeitung 05.10.06, p. 25; Börsenzeitung 31.10.06, p. 11; Süddeutsche Zeitung 31.10.06, p. 26; Frankfurter Allgemeine Zeitung 20.01.07, p. 14

[22] Handelsblatt 04.10.06, p. 21; managermagazin 8/2006, p. 75 ff.

remaining small shareholders to sell. However, the small shareholders were able to prevent the de-listing through resolutions at the next general meeting and a court case. The hedge fund Elliott brought a claim for damages, accusing the head of DIS of betraying company secrets to its (then) competitor Adecco. For the squeeze-out, DIS got an expert opinion which set the value of the company at €51.82 a share, and the minority shareholders were offered €55.80 as a settlement for their holdings. DIS shares at this point stood at €74 – in other words the market valued them substantially higher than DIS did. The aim of the hedge funds was that Adecco should buy them off with a significantly higher settlement offer so that they could make a profit on the difference in price. At the same time they exposed questionable and non-transparent ways of working at the two staff agencies.[23]

The disputes around the company running the German stock exchange *Deutsche Börse* were the result of Germany's largest case of hedge funds massively intervening in a company's strategy and completely changing its business plan. In spring 2005, several funds holding around 30% of the shares forced the board chair, Wolfgang Seifert and several members of the supervisory board to resign. They had objected to the hedge funds' plans to pay out to the shareholders resources that, among other things, had been intended for the acquisition of the London Stock Exchange (LSE). One of the consequences of stopping the purchase of the LSE by Deutsche Börse was that American exchanges were able to merge with European exchanges and so win influence in the restructuring of the fragmented European stock market landscape. Deutsche Börse was out of the game. In February 2007, the hedge funds' second attack began, as they called for the various business areas of the group to be made legally independent companies, with Deutsche Börse being restructured as nothing but a simple holding company over these individual operations. The better rating that this would produce would in turn allow more room for a further increase in the company's debt. The hedge funds called for the additional liquidity gained in this way to be paid out to the shareholders, and for a large-scale share buy-back programme.[24]

The German motor component maker *Schefenacker AG* is the world leader in car rear-view mirrors and sound systems. It is still 100% family-owned. However, the purchase of the rear-view mirror business from Britax International in 2000 led to difficulties for the company, as it had agreed too short a period for the credit it had taken on. The purchase proved to be less profitable than expected and Schefenacker was obliged to restructure its borrowings. New credit was taken on and the company issued a high-yield bond. However, this refinancing made the problem worse. Because the cash flows the company was achieving were too low,

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[23] Handelsblatt, 22.02.06, p. 14; Börsenzeitung, 23.03.06, p. 20; Börsenzeitung, 13.04.06, p. 12; Börsenzeitung 22.04.06, p. 9; Handelsblatt 07.06.06, p. 12; Börsenzeitung 09.06.06, p. 10; Börsenzeitung 10.06.06, p. 13; Handelsblatt 12.06.06, p. 19; Handelsblatt 21.06.06, p. 16; Börsenzeitung 12.07.06, p. 13; Börsenzeitung 04.11.06, p. 13

[24] Handelsblatt 10.05.05, p. 18; Börsenzeitung 11.05.05, p. 1, p. 5; Süddeutsche Zeitung 11.05.05, p. 30; Die Welt 12.05.05, p. 3; Handelsblatt 18.05.05, p. 25; Wirtschaftswoche 19.05.05, p. 48 ff.; Börsenzeitung 20.05.05, p. 2, p. 4, p. 9; Süddeutsche Zeitung 20.05.05, p. 25; Handelsblatt 20.05.05, p. 1; Frankfurter Allgemeine Zeitung 23.05.05; Frankfurter Allgemeine Zeitung 24.05.05, p. 29; Börsenzeitung 24.05.05, p. 3; Frankfurter Allgemeine Zeitung 27.05.05, p. 25; Frankfurter Allgemeine Zeitung 28.05.05, p. 21; Handelsblatt 12.09.05, p. 24;Süddeutsche Zeitung 24./25.02.2007, p. 28; Die Zeit 22.02.07, p. 23

the value of the bond fell sharply and hedge funds moved in massively to take it up. The German banks, which in the past had provided some sort of protection for Schefenacker, pulled out of their loans, which in turn were taken up by the 20 hedge funds that were involved. Schefenacker had been very transparent in placing the bond, and the hedge funds recognised that the company would fall into a liquidity trap and would be unable to service the interest on either the loans or the bond. A further problematic re-financing followed: a credit under the leadership of Citigroup-Bank in which only hedge funds participated and where the rate of interest varied according to the situation in capital markets.[25] With no opposition from Citigroup, the hedge funds forced up the price of this credit to an extremely high level of risk[26]and one of them, which by this point had brought the majority of the debts under its control, had only to wait. If the company recovered, the hedge fund would make substantial profits given the low price at which it had bought the debt and the high rate of interest. However, if the company was unable to repay its debts on time, the credit would be called in and the bankruptcy procedure begun. As the hedge funds and their associated banks would have a majority in the creditors' meeting, this would lead through a debt-for-equity swap to them forcibly taking over the company. In this way the company, which continues to produce world-class products, ended up under the control of the hedge funds, with consequences for the employees which are impossible to calculate.[27]

CeWe Color, the photo services company, is another case where management failure has provided an opportunity for hedge funds to attack. The company was engaged on a large scale in analogue photography, developing photos and films and providing a range of other services. It recognised – like many others, although possibly not early enough – the trend towards digital photography and started a massive switch from 2005 onwards. It cut jobs in the analogue area and invested in the digital area. The complete re-orientation of the business towards digital photography was to be achieved with existing liquidity. Hedge funds, which had acquired minority shareholdings in the company, are pushing – under the leadership of the Marcap fund (formerly M2Capital) – for the immediate distribution of the bulk of the available cash to the shareholders. However, the company needs all its financial resources in order to make the switch successfully. If the hedge funds were to succeed, the company would have too narrow a capital base to cope with possible setbacks and would run the risk of bankruptcy.[28]

TUI AG is Europe's largest travel group. It employs 63,000 people, and in 2005 it had a turnover of almost €20 billion and profits of €495 million. There are two business areas in the company – tourism and shipping. The company first became a

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[25] It was a revolving credit facility on a best effort basis.

[26] Finance Oktober 2005, p. 25 f.

[27] Finance, 10/05, p. 74-76; Börsenzeitung 31.08.06, p. 10; Börsenzeitung 14.09.06, p. 12; Börsenzeitung 14.10.06, p. 11; Financial Times Deutschland 16.10.06, p. 7; Frankfurter Allgemeine Zeitung 18.10.06, p. 21; Börsenzeitung 21.10.2006, p. 10; Frankfurter Allgemeine Zeitung 31.10.06, p. 26; Börsenzeitung 03.11.06, p. 14; Handelsblatt 22.11.06, p. 11, 13; Financial Times Deutschland 22.11.06, p. 10; Financial Times Deutschland 12.12.06, p. 2; Börsenzeitung 13.01.07, p. 11, finanztreff, Price of Schefenacker loan as at 01.02.07 14:00

[28] Süddeutsche Zeitung 31.01.07, p. 26; Handelsblatt 31.01.07, p. 12; Frankfurter Allgemeine Zeitung 31.01.07, p. 14; Süddeutsche Zeitung 16.02.07, p. 17; Süddeutsche Zeitung 20.02.07, p. 18

victim of hedge funds in August 2004 when they tried to speculate against the company's share price by short selling. At this point TUI AG was planning to float its shipping subsidiary, Hapag-Lloyd AG, on the stock exchange. The aim of the hedge funds was to reduce the overall market capitalisation of TUI AG and so force the company out of the DAX index (the part of the German stock market for large companies), which would have produced a further fall in its share price. The hedge funds speculated that, after such a fall, they would be able to repurchase shares in the company at a more favourable price and make profits in the spread between the selling and buying price. There was also the danger that a purchaser of TUI could split off the profitable logistics subsidiary Hapag-Lloyd and sell it on for a profit. The hedge funds' attack was beaten off, in part through the close co-operation between the management and supervisory boards, together with a number of defensive measures and early publication of good results. The flotation of Hapag-Lloyd was abandoned. At the annual general meeting in summer 2006, representatives of several investment groups with minority stakes called for the company to be broken up to increase the value of the two parts of the business – tourism and shipping – by splitting them apart. The strategy of the company up to this point had been to compensate for the variations in income from the tourism business, which is closely linked to the business cycle, with better results from shipping. However, as Hapag-Lloyd had moved into loss owing to higher fuel costs and lower freight prices, this strategy was now questioned by the investment funds. As a result of the pressure from capital markets, the group has for years undertaken cost-saving and restructuring programmes. It will not be possible to achieve improved operating results in the low-margin tourism business alone. Already more than 6,000 jobs have been cut in the tourism business since 2002. A further 2,000 jobs were lost worldwide as a result of TUI's takeover of the Canadian shipping company CP Ships at the end of 2005. Because of pressure from capital markets – or, to be more precise, investment funds – the two TUI airlines (HLF and HLX) are being integrated into a single brand, Tuifly. Under the new structure, which was announced in December 2006, some 3,600 posts are to go, including 400 in Germany.[29]

4. The economic impact of alternative investments on companies

A central element of the business model of private equity companies is that, through loading the target company with a high level of debt, they achieve an extremely high return on their own capital. In effect it is a transfer of assets from the company to the private equity fund. In the first instance this is achieved though the purchase being

[29] Handelsblatt 11.05.05, p. 25; Wirtschaftswoche 12.05.05, p. 113 f.; Hannoversche Allgemeine Zeitung 02.12.04, p. 11; Frankfurter Allgemeine Zeitung 29.08.05, p. 12; Financial Times Deutschland 04.09.06, p. 17; Börsenzeitung 28.09.06, p. 8; finance 10/06, p. 7274; Financial Times Deutschland 16.10.06, p. 1; Börsenzeitung 17.10.06, p. 9; Hannoversche Allgemeine Zeitung 07.11.06, p. 9; Süddeutsche Zeitung 10.11.06, p. 25; Financial Times Deutschland 10.11.06, p. 8; Börsenzeitung 10.11.06, p. 10; Hannoversche Allgemeine Zeitung 14.11.06, p. 9; Börsenzeitung 08.12.06, p. 9; Financial Times Deutschland 08.12.06, p. 6; Frankfurter Allgemeine Zeitung 08.12.06, p. 19; Süddeutsche Zeitung 08.12.06, p. 21; Süddeutsche Zeitung 11.12.06, p. 21; Handelsblatt 14.12.06, p. 14; Handelsblatt 14.12.06, p. 13; Frankfurter Allgemeine Zeitung 15.12.06, p. 22; Handelsblatt 15./16.12.06, p. 16; Handelsblatt 16.12.06, p. 18; Börsenzeitung 16.12.06, p. 1, p. 11; Frankfurter Allgemeine Zeitung 16.12.06, p. 15; Süddeutsche Zeitung 16./17.12.06, p. 25; Wirtschaftswoche 18.12.06, p. 80-82; Handelsblatt 18.12.06, p. 18; Financial Times Deutschland 18.12.06, p. 6; Finance 12/06, p. 66-68; Börsenzeitung 11.01.07, p. 11; Süddeutsche Zeitung 15.01.07, p. 19; Financial Times Deutschland 30.01.07, p. 11; www.faz.net 01.02.07

primarily financed with external capital. In the most recent period, on average around a quarter of the purchase of a company comes from the funds' own capital, with three-quarters being financed externally.[30] With these leveraged buyouts (LBOs) the return on the private equity funds' capital invested in the target company can be increased, provided the total rate of return from the target company is higher than the interest rate of the external borrowings. Taking on debt acts as a lever to increase the return on the funds' own invested capital – hence the name. The debt is transferred to the target company (debt push down), which is required to service it in the future. This can be a major burden on the company and the basic problem of debt can be further exacerbated by a number of typical ways of working that private equity funds employ as set out below.

"Dividend recapitalisation". This is a mechanism for paying out parts of the existing equity capital of the company or its hidden reserves. Hidden reserves can be revealed through a revaluation of the company's assets when it is taken over, if their book value in the balance sheet is less than their market value. A loan is taken out, in order to distribute the higher value of the assets to the fund. In other words, recapitalisations are dividends that are paid for through additional indebtedness. They represent a switch from equity to external capital and increase the level of debt, while at the same time removing assets. According to the ratings agency Fitch, financial investors recovered 64% of their own invested capital through recapitalisations after 29 months in major LBOs in 2004. In 2005 it was 77% of their own capital after just 20 months. [31]And for the first half of 2006 the figure has been calculated at an 86% recovery after 24 months.[32] In the period 2002 to 2005, studies from the rating agency Standard & Poor's indicate that the amount of recapitalisation increased tenfold to $40 billion a year.[33]

"Secondary sales". This is where the private equity fund "exits" from the target company by selling it to another financial investor. Exits of this type have significantly increased since 2003. They were the main way out for buyouts involving Mittelstand companies, accounting for 55% of the total, followed by 22% where the companies were sold to strategic investors and 17% where the companies where floated on the stock market.[34] Secondary sales drive up the selling price and the level of debt, and have already brought many companies to the brink of bankruptcy. The companies affected are particularly endangered by increases in interest rates or by worsened market conditions.

"Club deals". This refers to the purchase of large companies by a group of major financial investors. [35] In this way, large private equity companies can undertake purchases of a size that otherwise – because of the internal limits on the amounts spent on individual purchases – would be closed to them. Larger funds are also able

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[30] Frankfurter Allgemeine Zeitung 25.07.06, p. 17

[31] Frankfurter Allgemeine Zeitung 12.04.06, p. 25

[32] Frankfurter Allgemeine Zeitung 29.11.06, p. 24; Bundesbank 2005

[33] Handelsblatt 15.08.06, p. 23

[34] Börsenzeitung 21.12.06, p. 11

[35] The Economist 30.09.06, p. 86-88

to shut out smaller competitors in the private equity industry and divide the market for the purchase of large companies among themselves. At the end of 2006 the US Justice Department began an investigation into a number of funds suspected of illegal collusion.[36]

"New forms of organising finance". The banks, which provide the loans for the external financing of the private equity business, increasingly frequently sell these on in the market.[37] The loans are broken down into tranches, transformed into tradable securities (securitisation) and sold to institutional investors like CDO funds[38] and hedge funds. The funds get involved if, where a company collapses, there are negotiations around the restructuring of the financing. The UK regulatory authority the FSA noted in an understated comment that "in an extreme case these factors can undermine a restructuring".[39] In as far as the banks spread the credit risk in the financial markets, pressure on them to check the credit-worthiness of the borrower is reduced. In the USA, a large part of the loans provided for takeovers is taken up without any form of covenant (contractual clauses which protect the creditor).[40] Experts, like Todd Fisher from the investment company KKR, fear that the transfer of risk to the credit markets will produce an enormous credit bubble, which – with a substantial time delay – might burst.[41] There are also higher risks for financial markets as a result of the increased use of high-interest loans in the private equity business – these now account for around three-quarters of all loans of this type in the markets.[42]The loans that have been securitised and passed on to the markets by the banks do not stay in the balances of those who take them up. They pass them on again, frequently transformed into other forms of security, to market participants. This chain produces a gigantic volume of credit derivatives worldwide, whose value fluctuates between $17 and $26 trillion.[43] Major breakdowns can pass through this chain of financing producing a domino effect in financial and capital markets worldwide. In modern financial and capital markets, distributing risk means building up new risks at the same time. Investment banks, institutional investors, regulatory authorities and central banks have repeatedly taken up the theme of "systemic risk".[44]

"Early profit-taking, transferring risks into the distant future". Investment companies increasingly use forms of debt in which the interest and repayment are only due at the end of the period.[45] This leaves more resources for current operations, while the risks are left to some very distant point ahead, a time when the situation of the

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[36] Frankfurter Allgemeine Zeitung 08.12.06, p. 17

[37] Frankfurter Allgemeine Zeitung 07.09.06, p. 22

[38] CDO: Collateralrized Debt Obligations, transformation of loans into tradable securities which are generally grouped according to risk and given different rates of interest.

[39] Frankfurter Allgemeine Zeitung 08.11.06, p. 25; FSA 2006

[40] Handelsblatt 07.03.07, p. 28

[41] Frankfurter Allgemeine Zeitung 02.03.07, p. 25

[42] Börsenzeitung 28.11.06, p. 5

[43] Börsenzeitung 12.12.06, p. 17

[44] Die Zeit 31.08.06, p. 20; The Economist 23.09.06, p. 69-71; Handelsblatt 07.03.07, p. 28

[45] like footnote 43

company can hardly be foreseen and by which point the investment company may have exited. Generally the industry tries, through shortened periods of investment, early special dividends and the financial mechanisms just described, to realise the largest proportion of its returns in the first phase of its involvement.[46] Very short investment periods with substantial withdrawal of assets ("quick flips") have recently increased sharply.[47]

While private equity funds have to keep the target company operating effectively during the period they are involved, and have to take care that the company seems as valuable as possible at the point of sale, *hedge funds* hardly need to have such concerns in their engagement with companies. They try to take assets from the target company in a much short time than is the case with private equity companies. Whether – even in a very short time frame – the company is damaged in the process does not affect their business model, as Chapter 3 indicates. Hedge funds aggressively use the weaknesses of the companies affected or the possibilities of getting hold of resources that have been accumulated for future strategies. In their attacks they make efforts to win allies among other shareholders. In this they use the low levels of attendance at shareholders' general meetings that allow small minorities to pass the necessary resolutions. The TUI case above shows that hedge funds do not simply passively exploit the failures of other market participants to make arbitrage profits. They also actively manipulate companies' share prices, often employing large amounts of capital, in order to make profits by selling the shares short.

This reveals a central point: hedge funds and private equity companies deliberately operate in a way that is not transparent. An uneven distribution of information – information asymmetry – is one of the key reasons for market abuse.[48] Given that the funds produce this information asymmetry, they are among the most important causes of market failure. They change and manipulate the conditions in the market, which are hidden from other market participants, allowing them to be the first to profit from the informational advantage they have created. The accumulated super-returns of the hedge funds are counterbalanced by the accumulated extra risk borne by other market members.

The fact that companies are directed and monitored by capital markets is supposed to lead to higher level of efficiency. A great wealth of case studies suggests that, on the contrary, alternative investments themselves produce inefficiencies. Alternative investors fundamentally change the companies with which they are involved: right to the edge, such companies are relieved of "superfluous" capital, concentrated on an economic core area, optimised for short-term success, and freed of any too long-term planning. These companies are – in contrast to companies where investors have not been at work – more fragile, more prone to crisis; they have a colder social climate and worse working and wage conditions than beforehand. Both individual companies and the economy develop in a substantially more volatile way as a result of the influence of alternative investors. In many cases there are substantial job

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[46] Handelsblatt 06.11.06, p. 32

[47] Frankfurter Allgemeine Zeitung 25.07.06, p. 17

[48] Samuelson/Nordhaus 2005, p. 237 and p. 490

losses. Squeeze-outs often hit the small shareholders who, because of a lack of transparent processes and structures, are cheated with share prices that are too low or fall. The shareholder value approach creates partial improvement in economic growth and company competitiveness, but at a very high price.

In a LBO, because the current cash flow is largely used to service the debt, the company is unable to accumulate new assets. The removal of assets damages the future capability of the target company. There is a tendency for the company no longer to have sufficient resources to get through a crisis, for example a fall in sales. In the same way, long-term growth or research and development strategies are restricted. A private equity fund can behave in this way because it is only involved for a relatively short period of time. The fact that high indebtedness means the capital market will discount the value of the company when it later comes to be sold is already factored in by the private equity companies, as this is more than compensated for by the high returns taken from the company beforehand.

Extremely high company debt levels and large-scale asset stripping are the key elements of the activities of alternative investors. The "Börsenzeitung" and the well-known German company law expert, Uwe H. Schneider, talked in this context of "robbers of equity capital".[49] Indeed in many European countries, this development is being promoted by the state through tax concessions. Alternative investments also find it equally beneficial that they are based in tax havens.

5. The social impact of alternative investments on companies

Concrete cases show how purchases with leveraged finance, special dividends and high debt level of the target companies have destroyed jobs to a substantial degree. Around a third of the jobs went at the AA in the UK, at Grohe it was almost 20% and at Edscha it was almost 15% that were lost. And at Kiekert, only some 1,500 of the 4,000 jobs there were in Germany in 2000 still remain, and the number is set to fall further. Over and above this, the target companies with their thinned-down capital backing are generally worse armed for the future than they were before the arrival of the private equity funds, potentially leaving more jobs or even whole companies in danger.

The few academic studies undertaken into the employment effect of alternative investments have overwhelmingly been produced on behalf of the funds. It is therefore no surprise that they come to the conclusion that hedge funds and private equity funds create lots of jobs. Generally there is no evidence of *net* job creation.[50] Where this is provided, it is done in a very questionable way, in terms of research design and methodology. This was the case for a study undertaken by the consultancy A.T. Kearney in 2006. In it the claim was made that PE investment had created about one million new jobs in Europe over the period 2002 to 2005.[51] However, this was a meta-study based on 12 studies, almost all of which had been

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[49] Börsenzeitung 26.08.06, p. 8

[50] For example, the study by PriceWaterhouseCooper (see bibliography PWC 2005), undertaken with financial support from the Geman Bundesverband Deutscher Kapitalbeteiligungsgesellschaften – German Private Equity And Venture Capital Association e.V. – BVK

[51] A.T.Kearney 2006; Handelsblatt 19.12.06, p. 1

commissioned by the PE industry, and which were frequently carried out by institutions that had a positive interest in the funds, because the funds are their customers. The methodologically questionable approach of these individual studies was carried over into the meta-study and led to distorted or incorrect interpretations.[52] Reliable academic investigations into the economic, social and societal impact of alternative investment fail almost from the start, because the most important of the data necessary for them is not available.

In many of the target companies, private equity investments lead to a worsening of working conditions. At the German car repair chain A.T.U. employee productivity was increased through lengthening working time and increased work intensity. The excessive cuts in the workforce at the AA, the UK motoring organisation, led to an overloading of the workforce and a significant worsening of service quality. At Gate Gourmet, the investment company pursued an extremely aggressive and hidden strategy directed against the staff.

The Hans Böckler Foundation has interviewed works council members in companies where financial investors have been involved.[53] The Grohe works council members say that the financial investors who are currently involved in the company (Texas Pacific Group, Credit Suisse First Boston) have, following on from the restructuring, continually tried to play off the various sites of the company and their workforces against one another. They experienced the representatives of the financial investors as people who had no emotional connection to the Grohe brand or to its products. TPG and CSFB did not identify themselves with the company or its employees; rather they saw Grohe as a financial product. The works council members describe the relationship with TPG and CSFB as markedly characterised by conflict; the co-operation and the culture in the company has become radically worse.[54] The reports from works council members in the other companies referred to above were similar. Achieving reconciliation between the economic interests of the owners and the workforce is, in these circumstances, made more difficult, if not impossible.

6. Overall economic and social effects

Alternative investments function as a worldwide instrument for redistribution. They search out worthwhile targets that have “too much superfluous” or “unproductively tied-up” capital, with the aim of getting hold of these assets for themselves. It is interesting to follow the path of the capital that is released in this way. First, a part of

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[52] A study by PWC on behalf of the private equity association BVK (see footnote 49), which is one of the 12 sources, includes a number of methodological failings as well as academically problematic procedures. The BVK/PWC study is based on the evaluation of questionnaires sent to private equity companies who were BVK members. The authors themselves say that the companies covered were not a representative sample of the industry. There are a number of important and influential variables that are not and cannot be held constant in the study, although this would be a necessary first step in making a comparison with companies not owned by private equity funds. In addition some studies make the methodological mistake of a simple comparison between companies in which alternative investors are involved and those where they are not. This ignores the fact that, from the outset, funds only concentrate on “worthwhile” companies – that is, those which, without the influence of alternative investments, have significantly better economic potential than the average company.

[53] http://www.boeckler.de/cps/rde/xchg/SID-3D0AB75D-871E238A/hbs/hs.xsl/396_48994.html

[54] Blome-Drees/Rang 2006.

it is invested in other worthwhile targets, in order to turn the screw further and release more capital. A second portion goes to institutional investors and wealthy private individuals. The payments are made to pension funds, who are increasingly on the lookout for investments offering a high return, and the highly risky alternative investments make future pension payments less certain and more precarious. Banks and insurance companies, as well as other institutional investors, drive up their returns through involvement in hedge funds and private equity funds. University foundations, which invest in higher education, are among the institutions involved. Thirdly, a substantial part of the wealth taken from the target companies goes to the individuals who are involved in the alternative investments business. Sometimes the managers of the “general partners” of hedge funds – the people who run the business – keep up to 50% of the returns they achieve for themselves. Managers of private equity companies and partnerships also have an extremely high share of the profits if the business is performing well. The “partners” in private equity funds – a handful of individuals – normally get 20% of the overall profit (“carry interest”). Nicholas Ferguson, head of the UK private equity investor SVG Capital, has estimated that private equity companies made a total profit of around $430 billion in the period 1996 to 2006. On this basis the partners’ share of the profits works out at around $86 billion.[55] External groups, working with the funds, such as prime brokers, specialist law firms and consultants, also receive enormously high revenues. The extremely high incomes of the individuals involved leads to great concentrations of wealth around them and sometimes to luxurious levels of consumption – in other words, a redistribution of society’s resources towards the production and consumption of luxury goods.[56]

Financial investors are both the advance guard and the supporters of a development in which companies themselves become a commodity to be quickly bought and sold. Companies in Europe companies are traditionally tied into a range of links which makes it more difficult for them to be traded in this way. These include protection against dismissal, compensation for redundancy, the ongoing validity of collective agreements when companies are transferred, the involvement of employees in company decisions (either through co-determination or in other ways), environment regulations, tax rules which aim to preserve a company’s existence, and laws that make company takeovers more difficult. Beyond the legislative requirements, traditional managers are more likely to demonstrate a feeling of responsibility towards the employees or towards the region in which the company is based. In order to make companies more tradable in capital markets, the links a company has with its surroundings must be cut and the influence of stakeholders other than the shareholders must be eliminated.

The incentives of the capital and financial markets are also remoulding the banking sector. In the capitalism of financial markets the banks are also looking for super returns and organise their business around the needs of the capital market and its most important players. They have discovered the chances of high rates of return

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[55] Frankfurter Allgemeine Zeitung 24.11.06, p. 25

[56] Die Zeit 20.12.06, S. 23; Frankfurter Allgemeine Zeitung 21.12.06, S. 11; The Economist 21.10.06; The bonuses for the heads of Investment Banking at Barclays and at Goldman Sachs for 2006 have been estimated by insiders at between €60 and €70 billion each. The hierarchies below them similarly benefit from high bonuses.: Süddeutsche Zeitung 10./11.02.07,p. 36

offered by alternative investments: investing in hedge funds and private equity funds, floating their own funds[57], taking on the job of prime broker for hedge funds, selling loans to financial investors, and acting as managers for company takeovers. The expectation of high returns from doing business with small private customers has also grown in parallel. Levels of private debt for British citizens have reached a historic high and are twice as high as elsewhere in Europe. The number of private bankruptcies has increased very sharply.[58] And there are similar developments in the USA.[59]

The ideas of shareholder value and short-term thinking have gained substantial ground in the overall economy. Companies and managers which do not go along with these principles become the targets for attacks from raiders. The DAX companies substantially reduced their debt levels between 2002 and 2005. In 2002 on average, the value of external capital was equivalent to 4.96 times pre-tax profits in the 30 DAX companies, but by 2005 it had fallen to 3.01.[60] Together with low levels of debt, most DAX companies also have a high free cash flow and low growth. This makes them interesting takeover targets for financial investors, who could load them with large amounts of additional debt. Companies in the top tiers of stock exchanges in individual European counties are increasing moving into the field of view of alternative investments, as their own resources grow. These companies have felt themselves obliged to adopt defence strategies ("poison pills") to ward off attacks – for example, through themselves taking on high levels of debt, large-scale acquisitions, share buy-backs, high dividend payments, and a massive concentration on their core business.[61] There was a very similar development in 1980s in the USA.[62]

This short-term approach is evident in the quarterly reports which are now widespread. Analysts measure the quarterly results against their own forecasts and so influence investors. Companies concentrate on short timescales and neglect long-term company development. Fraudulent accounting has grown alongside quarterly reporting.[63] And criticism of the increasing short-term approach is heard from US as well as European industry. In 2006, when financial investors offered to purchase the semiconductor maker Freescale, the US semiconductor association warned that US chip-makers could suffer if they came under private equity control. The association warned that it was a industry for long-term planning and investment, and expressed great doubts that this would be possible with financial investors.[64]

In bank-driven systems – the position in most European countries until a few years ago – companies are controlled through internal bodies and relationships ("insider

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[57] Handelsblatt 22.08.06, p. 26

[58] Süddeutsche Zeitung, 24./25.02.07, p. 28

[59] Handelsblatt 07.03.07, S. 28; Süddeutsche Zeitung 06.03.07, p. 26

[60] Financial Times Deutschland 22.12.06, p. 32

[61] Handelsblatt 02.02.06, p. 21

[62] Kaufmann/Englander 1993, p. 84

[63] Collingwood 2001

[64] Financial Times Deutschland, 22.11.06, p. 19

control"). Supervisory boards, representatives of the banks, management and employee representatives, politicians and customers – stakeholders in other words – oversee the business. In a system driven by capital markets, the monitoring and direction is provided by the market ("outsider control"). [65] This system of corporate governance operates with a high level of external transparency in terms of the company's activity. The company is evaluated by ratings agencies and analysts, and shareholders intervene in the company's structures and strategies.

Representatives of this system consider that the external control by capital markets is far superior to the internal control of bank-driven systems. However, the scandals at Enron, WoldCom, Computer Associates and many other companies in the USA show the extent to which external company control can fail – as a consequence of the system.[66] Large-scale false accounting, pre-dating of stock options[67], insider trading[68] and other criminal acts have had negative consequences for companies, employees and small investors. This system provides incentives to managers which motivate them to behave criminally.[69] It encourages and promotes a certain type of manager – someone very prepared to take risks, with great talent in getting maximum short-term returns, indifferent to production and employees, rigorous in restructuring the company and focused on an extremely high individual income. If there is then fraud and markets are disturbed, state bodies are required to take massive corrective action.

In 2002 the US state introduced an extensive system of regulation with accountancy and supervisory rules to stop future financial frauds of the type listed above.[70] It was named the Sarbanes-Oxley Act after the two senators of the US Congress who initiated it. However, a few years later business was complaining about the high costs and bureaucratic procedures that the legislation required.[71] American history is full of state regulation of a similar or even greater size.[72] It indicates how the great reservations about the state setting rules for where things go wrong, almost inevitably lead to failures precisely because of this. These in turn require an even bigger state intervention. In addition, in systems directed by capital markets, there is paradoxically a strong tendency for quoted companies to be removed from this highly praised system of capital market control when they are de-listed.[73]

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[65] Hackethal/Schmidt/Tyrell 2005

[66] Windolf 2003; Handelsblatt 03.04.06, p. 11; Frankfurter Allgemeine Zeitung 25.10.06, p. 26; Süddeutsche Zeitung 04/05.11.06, p. 26

[67] Handelsblatt 15.01.07, p. 11; The Economist 21.10.06, p. 73-74; Frankfurter Allgemeine Zeitung 19.10.06, p. 23; Frankfurter Allgemeine Zeitung 31.08.06, p. 23; Financial Times Deutschland 21.08.06, p. 25; Süddeutsche Zeitung 26.07.06, p. 26

[68] Frankfurter Allgemeine Zeitung 16.09.06, p. 21; Frankfurter Allgemeine Zeitung 20.03.06, p. 14; Handelsblatt 05.03.07, p. 26; Handelsblatt 02./03./04.03.07, p. 21; Frankfurter Allgemeine Zeitung 07.12.07, p. 21

[69] Süddeutsche Zeitung 15.02.07, p. 4

[70] Kamp/Krieger 2005, p. 66

[71] Börsenzeitung 17.11.06, p. 6; Börsenzeitung 08.07.06, p. 13; Handelsblatt 26.06.06, p. 17; The Economist 22.04.06, p. 59-60; Handelsblatt 14.03.06, p. 16; Börsenzeitung 24.01.06, p. 21

[72] Kaufmann/Englander 1993

[73] The Economist 25.11.06, p. 78

It is frequently claimed that companies perform better if they are exposed to the pressure of capital markets. There are academic studies which contradict this thesis. An MIT study found that the value of highly indebted companies grew less rapidly than companies investing for the long term.[74] More recent research from Germany showed that family-led companies had a clearly better performance than other companies[75]: the GEX – the part of the German stock exchange covering family-led companies – has done better than the DAX.[76] The case studies in Chapters 2 and 3 also show that the core of the business model of both private equity and hedge funds lies in taking value from companies to a point at which it becomes problematic. Experts consider that the private equity market has since 2006 moved into an overheating phase; it has done this on a number of occasions in the past.[77] It is working with increasingly greater levels of leverage, aided by very low interest rates in the market and a worldwide excess of liquidity in financial markets. Johannes Huth, the head of KKR in Europe has talked of a dangerous "liquidity bubble".[78] The ratings agency Standard & Poor's has reported that the indebtedness of target companies where private equity was involved had risen to 5.8 times the value of their operating results (EBITDA) – an extremely high figure. In 2002 the equivalent figure was only 4.3.[79] Low interest rates offer a greater potential to increase returns on the private equity capital invested through higher levels of debt in the target companies. Companies are often bought at exaggeratedly high prices, which leads to more debt being loaded on the companies. Experts emphasize that the degree of leverage and the extent of the debt have now reached dangerous levels. Increasingly, strategic investors cannot match the prices offered by private equity funds, and the target companies cannot find a home with long-term investors. Edgar Meister, a board member of the German Bundesbank, has stated that high debts make companies vulnerable. Increased interest rates or a slight worsening of the economic situation could lead to the bankruptcy of the companies affected.[80] Many of those involved in the private equity industry expect that, in this overstretched market, there will be major loan defaults.[81]

Players on the capital markets stress that the risks of alternative investments can now be controlled. In their view, a case like LTCM in 1998, where the collapse of a hedge fund produced major disruption in both capital and financial markets could no longer occur, as hedge funds now operate effective risk management. Prime brokers

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[74] MIT 2001

[75] Financial Times Deutschland 04.07.06

[76] Handelsblatt 19.02.07, p. 1

[77] Börsenzeitung 15.12.06, p. 5; Financial Times Deutschland 05.12.06, p. 29; Frankfurter Allgemeine Zeitung 29.11.06, p. 24; Handelsblatt 28.11.06, p. 25; Frankfurter Allgemeine Zeitung 08.11.06, p. 25; Handelsblatt 31.10.06, p. 30; Der Spiegel 47/2006, p. 94; Frankfurter Allgemeine Zeitung 04.10.06, p. 25; Frankfurter Allgemeine Zeitung 01.08.06, p. 11; Frankfurter Allgemeine Zeitung 29.07.06, p. 21; Frankfurter Allgemeine Zeitung 29.06.06, p. 21; The Economist 24.06.06, p. 84-85; The Economist 18.02.06, p. 61-62

[78] Handelsblatt 29.11.06, p. 21

[79] Süddeutsche Zeitung 20.03.07, p. 26

[80] Handelsblatt 29.11.06, p. 21

[81] Frankfurter Allgemeine Zeitung 04.10.06, p. 25; Financial Times Deutschland 15.09.06, p. 21

– investment banks which provide services for hedge funds – involve themselves effectively in risk avoidance. However, more recent cases shown that the dangers have not been eliminated. In September 2006, the hedge fund Amaranth made a $6.5 billion loss because it had placed two-thirds of the assets it managed in a single transaction – a bet on gas price movements.[82] The American investment banker Bear Stearns, one of the largest providers of prime broker services worldwide, did not investigate frauds discovered at the hedge fund Manhattan Investment Fund. Investors lost $400 million through the collapse of the fund.[83] Similar cases continue to have the potential to produce major disruptions in the markets.

It is calculated that some 9,000 hedge funds worldwide manage assets worth around €1,400 billion,[84] and experts estimate that hedge funds currently account for about one third the trading volume on the major stock markets.[85] Given their high leverage, they can probably move amounts of around $3,500 billion.[86] At the start of the 1990s hedge funds only managed around $100 billion.[87] The risks are heightened by the fact that the funds used highly leveraged derivative instruments[88] and a further concern is that funds increasingly act together.[89] Finally the risk is increased by the lack of transparency in the way the funds behave. Hedge funds often intervene on a massive scale in company takeovers and have a decisive influence on the price and the conditions of the deal.[90] These interconnections demonstrate the potential damage that hedge funds can do.

Alternative investors have shown great interest in formerly state-owned areas which have been privatised, as well as sectors of the economy – like newspaper publishers, TV and radio companies, cable and communications companies, energy and water supply, waste disposal and recycling, health[91] and housing – which have a great public importance. Running these areas simply along the lines of the shareholder value approach is highly problematic. It is hardly possible to produce a quality newspaper delivering top-level returns. The UK investment group Mecom, led by David Montgomery, increased returns in newspaper publishing largely through large-scale redundancies, and those affected accused the investment company of having no well thought-out idea of publishing.[92] George Soros, who founded the

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[82] Der Spiegel 39/2006; Handelsblatt 20.09.06, p. 25; Frankfurter Allgemeine Zeitung 22.09.06, p. 21; Financial Times Deutschland 29.09.2006, p. 20; Handelsblatt 10.01.07, p. 25

[83] Handelsblatt 19.02.07, p. 27

[84] Handelsblatt 06.02.07, p. 3

[85] Frankfurter Allgemeine Zeitung 08.02.07, p. 19

[86] Financial Times Deutschland 12.12.2006, p. 17

[87] Financial Times Deutschland 29.09.2006, p. 20

[88] Derivatives like futures, options, depositary receipts, warrants (securitised options), forwards or swaps depend on underlying assets or sometimes the indices of the real asset but fluctuate in value much more than the movements of the underlying assets. They reflect the underlying movements in a leveraged way, and so result in greater gains and losses.

[89] Börsenzeitung 31.05.06, p. 17; ECB 2006; Bundesbank 2005

[90] Handelsblatt 20.02.2007, p. 24

[91] Börsenzeitung 29.08.06, p. 10

[92] Frankfurter Allgemeine Zeitung 21.12.06, p. 36

hedge fund Quantum, has complained of the fall in both the quality and the diversity of opinion in the American newspaper landscape as a result of the intervention of the US capital market.[93] The involvement of private equity in housing often has problematic consequences – investments are cut back, rents are increased and housing quality falls. This is shown by examples like Viterra in Germany, a housing company which the UK investment company Terra Firm bought from the energy group E.on for €7 billion,[94] and the takeover of the housing companies Gagfah and Woba by the American investor Fortress.[95]

The impact of alternative investments on the economy helps to drive forward a general movement producing increasingly greater inequalities. These investments lead to enormous incomes for managers,[96] both of the companies and of the hedge funds and private equity funds. At the other end of the employment ladder, incomes are under pressure. The increasing inequality in society is particularly noticeable in developments in the USA[97], but the same trend can also be seen in European countries. The poverty of the lower strata grows; their education and life chances get worse.

7. Reasons and starting points for the regulation of alternative investments

In some areas, such as the provision of risk capital for new business models, financial investors have an important function. Here they should have the chance to be active. On the other hand, differentiated regulatory measures are necessary to help avoid the high potential of alternative investments to increase risk and cause damage. Indirect regulation – for example, through prime brokers in the case of hedge funds – will, in the view of important experts, not produce the desired results.[98]

The substantial market disturbances that have been caused by alternative investments show that there is a need for regulation. The crises around the hedge funds Amaranth and Bear Stearns led to the reopening of a critical debate about funds of this type and, for the first time, their regulation has been a topic at a G7/G8 summit.[99] Both German and French politicians have pushed for tighter controls on hedge funds, and the French presidential candidate Nicholas Sarkozy has emphasised the necessity for moral values and security requirements in finance

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[93] Der Spiegel 47/2006, p. 94

[94] Die Zeit 23.06.05, p. 22; Handelsblatt 18.05.05, p. 13, Börsenzeitung 18.05.05; Financial Times Deutschland 19.05.05, p. 22; Süddeutsche Zeitung 20.06.05, p. 25; Börsenzeitung 11.08.05, p. 6; Financial Times Deutschland 19.08.05, p. 17;Financial Times Deutschland 30.08.05, p. 2; Süddeutsche Zeitung 07.09.05, p. 24; Company report Dt. Annington 2005; Press statement Dt. Annington, 17.01.07; Börsenzeitung 18.01.07, p. 1 und p. 2; Handelsblatt 05.03.07, p. 22

[95] Financial Times Deutschland 01.04.05; Frankfurter Allgemeine Zeitung 16.02.07, p. 41

[96] Chahed/Müller 2006

[97] Der Spiegel 38/2006, p. 96 ff.; Frankfurter Allgemeine Zeitung 01.03.07

[98] This is the view of Edgar Meister, board member of the German Bundesbank, who says that prime brokers only have knowledge of parts of a hedge fund's business and that a complete overview of the total risk situation of the fund is kept from them. Frankfurter Allgemeine Zeitung 14.02.2007, p. 20

[99] Börsenzeitung 22.09.06, p. 6

capitalism.[100] Even representatives of the industry like Stanley Fink, head of the Man Group, one of the world's largest providers of hedge funds, have called for strict controls.[101] The Federation of German Industries (BDI) has expressed similar views.[102] Central banks and national regulatory authorities in both the USA and a number of European countries have described the manifold potential for risks of alternative investments, although "at present" they see no great need for regulation.[103] Charlie McCreevy, the EU's internal market Commissioner, has responded to this critical debate with sharp attacks on politicians and regulators. So far, he says, the stability of the financial system has not been threatened. Some people, in McCreevy's view, want hedge funds to be "regulated to death". But hedge funds and private equity funds have "… provided markets with liquidity, increased the value of companies and supported company rationalisation and innovation". [104]

In the view of the expert group of the Party of European Socialists (PES), economic activity in Europe should be measured against the criteria of the European Social Model.[105] This means taking account of the interests of all important stakeholders in a company. Three targets flow from the European Social Model as minimum regulatory demands:

- the abolition of specific preferential treatment for alternative investments by the state;
- limits on the ability to strip assets from a company, particularly in the case of investments aimed at the short-term maximising of returns; and
- a check on the excesses that unbridled financial and capital markets can produce: exceptionally high management salaries, the lack of transparency of alternative investments, high company indebtedness, the circumvention or blocking of company strategies through minority stakes, and the creation of market distortions by the funds.

Regulation should start with the following concrete points:

- creating transparency about hedge funds and private equity funds with data on topics such as the investors involved, investments held in companies (starting with a requirement to declare holdings of 1% and above), a complete description of all prime brokers involved and the business undertaken with them (particularly the credit obligations), public disclosure of the strategies being followed (such as short-selling and its extent), the degree of leverage being used in transactions above a certain size, the derivative instruments being used, and risk reporting (with indicators that are both effective and meaningful);

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[100] Financial Times Deutschland 15.02.07, p. 12

[101] Financial Times Deutschland 22.09.2006, p. 23

[102] Frankfurter Allgemeine Zeitung 09.03.07, p. 15

[103] FSA 2005; FSA 2006; Bundesbank 2006; ECB 2005; ECB 2006

[104] Financial Times Deutschland 20.02.07, p. 18

[105] PSE 2006

- limits on the level of debt placed on companies as part of an acquisition and limits on the degree of leverage – consideration could be given to guideline figures on debt linked to the purchase price of the company or the value of its equity capital – and restrictions on debt push down (the possibility of loading debt onto the target company);
- limits on the ability to pay out super dividends (dividend recaps) and to take on credit to pay for them;
- statutory rules on voting at shareholders' general meetings with the aim of making resolutions promoted by minority shareholders more difficult, voting advantages for long-term shareholders, tightening of the "acting in concert" rules;
- limits on the possibility of forcing out minority shareholders;
- making hostile takeovers more difficult, strengthening the rights of the supervisory bodies within companies, banning the payment of bonuses to managers in target companies for their consent to a takeover;
- tax arrangements: no possibility of offsetting the cost of credit produced through taking on external finance to pay for a takeover against profits, higher taxation for short-term involvement, taxation of fund managers' income, taxation at source on the returns from sale of investments and dividends from target companies, normal corporation tax and business tax for the management firms of funds (no tax relief based on classification as an asset manager), and tax discrimination against offshore business and offshore companies;
- limits on the extent to which pension funds and insurance companies can invest in alternative investments (for example, a maximum 5% or 10% of the total value invested);
- no access to public markets or small investors (retailing) for alternative investments; and
- limits on hedge funds' ability to use derivatives whose impact has not been investigated or is unknown.

The European Social Model stands in opposition to the shareholder-value approach. It flows from it that a company has to serve the interests of others involved as well as the justified interests of the shareholders. In the first instance these are the employees and their need for secure and attractive jobs, for good working conditions, for a reasonable income and generally for good opportunities in life. Companies, which take advantage of society's infrastructure and individuals' qualifications to an enormous degree, have both an economic and a moral duty to benefit society in return. Society allows companies to set up and be active. Once established – in a society with social values – they have a responsibility for their employees and for the development of that society. It is illegitimate for alternative investments to transform companies and their employees into tradable commodities. If Europe consciously decides in favour of the European Social Model and against complete external control of companies by the capital market, then it must be willing to pursue policies which involve appropriate regulatory instruments and agreed state intervention at European level.

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