America for Sale? An Examination of the Practices of Private Funds

Committee on Financial Services
U.S. House of Representatives

November 19, 2019

Testimony Submitted by AFL-CIO

Chairwoman Waters, Ranking Member McHenry, and the Members of the Committee, thank you for the opportunity to submit this letter for the record for the hearing, "America for Sale? An Examination of the Practices of Private Funds." The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), commends the Committee on Financial Services for holding this important hearing to consider the negative impact of private equity (PE) on our economy and working people.

The AFL-CIO is America's labor federation representing 55 national and international labor unions and more than 12.5 million working people. We strive to ensure that all working people are treated fairly with decent paychecks, good benefits, safe jobs, dignity, and equal opportunities. Working people need a well-regulated financial system that supports sustainable economic growth and a fair return on our work. We oppose the predatory practices of the PE industry that jeopardize the well-being of companies and workers.

The retirement savings of working people that are invested in PE funds also need protection. Since its founding, the AFL-CIO has fought for the retirement security of working people—through advocacy for Social Security and Medicare, and through collective bargaining for pension plans with employers. Today, working people have over $15 trillion in retirement plan assets. Those of us fortunate to have retirement savings need a safe place to invest. The PE industry needs to be made more accountable and transparent to pension plan investors.

The Stop Wall Street Looting Act

We are pleased to endorse the Stop Wall Street Looting Act (the "SWLSA") (H.R. 3848) that was introduced by Representatives Pocan, Jayapal, García, Grijalva, Khanna, Lee, Pressley, Schakowsky, and Tlaib earlier this year. If enacted, the SWSLA will shut down a series of loopholes in the securities, bankruptcy and tax laws that allow a handful of Wall Street millionaires and billionaires to profit at the expense of working people. It will:

- Make PE general partners ("GPs") accountable for damages suffered by workers when their employers end up in bankruptcy after a PE firm takes over;
- Require GPs to be accountable to pension investors and provide information about what they're doing with pensioners' money; and

- Close the carried interest tax loophole, which allows GPs to pay lower federal tax rates than regular working people.

The SWSLA will close exemptions in the securities laws that allow PE firms to avoid the disclosure requirements and U.S. Securities and Exchange Commission oversight applicable to other pooled investment vehicles. Like mutual funds, PE funds are of a similar size and impact in terms of the number and relative wealth of the individuals whose retirements and job security depend on their performance.

The SWSLA will also address loopholes in our bankruptcy and tax laws. The bankruptcy laws allow GPs to load companies with debt, pay themselves dividends, and walk away without any responsibility if the company ends up in bankruptcy. PE GPs also take advantage of tax loopholes such as the carried interest tax loophole and receive tax benefits when monitoring fees, payments they receive in exchange for consulting and advisory services, are considered business expenses allowing them to lower their tax bills.

The Private Equity Investment Model

The PE investment model allows extremely wealthy GPs to take control of real economy businesses, which provide goods and services of value to the public, and extract wealth from these businesses. As a result, these PE-acquired companies are placed at greater risk of bankruptcy. This is accomplished using capital provided by outside investors, many of which are pension plans who pay exorbitant fees to the GPs for the privilege of investing.

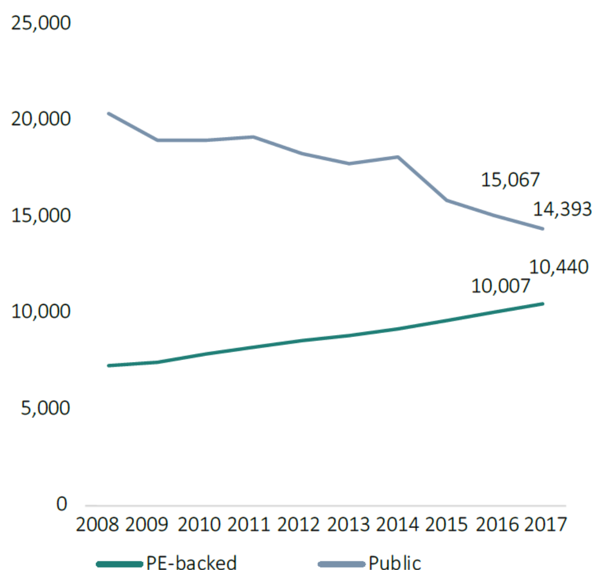
The PE investment model is having a growing impact on the U.S. economy. Assets held by PE firms have increased from $1 trillion prior to the financial crisis to a new record of $3.1 trillion in 2017, with another $1 trillion in committed capital waiting to be invested.
[1] Today, PE-owned companies employ 8.8 million American workers.[2] We have seen a decline in the number of publicly-traded companies over the last decade, while at the same time, the number of PE-backed companies has grown rapidly.

[1] *Press Release: Private Equity Industry Grows to More Than $3tn in Assets*, Preqin, Jul. 24, 2018 *available at* http://docs.preqin.com/press/PE-Assets-Jul-18.pdf.

[2] Economic contribution of the US private equity sector in 2018, prepared by Ernst and Young for the American Investment Council, Oct. 2019, *available at* https://thisisprivateequity.com/wp-content/uploads/2019/10/EY-AIC-PE-economic-contribution-report-10-16-2019.pdf.

Convergence between public and PE-backed companies continues

North American and European companies (#) by backing status



Source: PitchBook

Note: Due to a lag in the reported data, this data is presented through full-year 2017.

Comment by Eileen Appelbaum to FTC on Proposed Consent Agreement in the Matter of Staples/Essendant, Inc.

The term "private equity" is polite word for leveraged buyouts which gained notoriety in the 1980s. A leveraged buyout is a financing technique to acquire a company using a small amount of equity and a large amount of debt. PE GPs usually put a small amount of their own money towards the down payment, 1-3%. The remainder of the equity investment is provided by investors such as pension funds and wealthy individuals. In a typical leveraged buyout, around 30% of the purchase price is paid in as equity, and 70% is debt financing.[3]

When a PE fund acquires a company through a leveraged buyout, the acquired company is responsible for paying down the resulting loans, not the GP or its investors. Loan payments are paid out of the acquired company's earnings. If the company cannot make the payments, the PE fund is not responsible for the company's debts. It is common practice for a company that has been acquired in a leveraged buyout to take out additional loans to pay a special dividend to the acquiring PE fund in what is called a "dividend recapitalization."

Recent increases in the issuance of loans which are used to finance leveraged buyouts are raising concerns among regulators domestically and globally.[4] In the past five years, the value of

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[3] *Id.*

[4] Jim Puzzanghera, *Remember the subprime mortgage mess? $1.2 trillion in risky corporate debt is flashing similar warning signs*, LA Times, Jan. 20, 2019, *available at* https://www.latimes.com/business/la-fi-corporate-debt-risks-20190120-story.html.

outstanding leveraged loans has nearly doubled to $1.19 trillion.[5] Regulators are concerned that an economic downturn could lead to a wave of defaults.

Late last year, the Federal Reserve issued a Financial Stability Report which raised concerns about high levels of corporate debt and the increase in risky lending practices.[6] The report stated, "lenders have become more willing to extend loans with fewer credit protections to higher-risk borrowers. Moody's Loan Covenant Quality Indicator suggests that loan covenants are at their weakest levels since the index began in 2012..." [7]

The growth of leveraged lending market also poses systemic risks to our economy. In October 2018, Former Federal Reserve Chair Janet Yellen raised concerns, explaining that "I am worried about the systemic risks associated with these loans…There has been a huge deterioration in standards; covenants have been loosened in leveraged lending."[8]

Private Equity and Working People

The debt-servicing burden that a leveraged buyout imposes on a PE-acquired company often forces the company to forego investments that would make the company more competitive. PE industry observers are concerned that this investment strategy can result in lower wages and benefits for working people. PE acquired companies are also at greater risk of bankruptcy and layoffs. One analyst has concluded that more than 60% of the lost retail jobs between 2016 and 2017 -- around 130,000 jobs -- were at companies owned by PE firms.
[9] Below are three examples of how PE firms have destroyed jobs through leveraged buyouts.

1. Caesars Entertainment Corporation

The casino company Caesars Entertainment Corporation (formerly Harrah's Entertainment), was purchased by PE firms Apollo and TPG in a 2008 leveraged buyout that was financed using $23 billion of debt.[10] The company then conducted a series of financial engineering maneuver, culminating in a complicated bankruptcy and an asset sale.[11]

Under Apollo and TPG, Caesars made dramatic cuts to investments in its properties and its workforce. Before the leveraged buyout, Caesars spent $2.5 billion in 2006, $1.5 billion in 2007,

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[5] *Id.* See also *Risk-off shift brings banks back to leveraged loan market,* S&P Global Market Intelligence, Apr. 8, 2019, *available at* https://www.spglobal.com/marketintelligence/en/news-insights/trending/eCZ7eZ4RH8dpwSArc_UCbQ2.
[6] Board of Governors of the Federal Reserve System, *Financial Stability Report,* Nov. 2018, *available at* https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf.
[7] *Id at 12.*
[8] Sam Felming, *Janet Yellen sounds alarm over plunging loan standards*, Financial Times, Oct. 25, 2018 *available at* https://www.ft.com/content/04352e76-d792-11e8-a854-33d6f82e62f8.
[9] Steve LeVine, *Vulture capitalists are killing off retail jobs*¸ Axios, Jan. 10, 2018 *available at* https://www.axios.com/private-equity-1515603080-efd39541-a9fb-474b-8c24-04623ee518fd.html.
[10] Gretchen Morgenson, *Caesars' Debt: A Game of Dealer's Choice*, NY Times, Sep. 13, 2014, *available at* https://www.nytimes.com/2014/09/14/business/caesars-debt-a-game-of-dealers-choice.html.
[11] Sujeet Indap, *What happens in Vegas . . . the messy bankruptcy of Caesars Entertainment*, Financial Times, Sep. 26, 2017, *available at* https://www.ft.com/content/a0ed27c6-a2d4-11e7-b797-b61809486fe2.

and $1.8 billion in 2008, or an average of $1.7 billion per year on capital expenditures to renovate and build new properties.[12] Between 2009 and 2016, under the Wall Street firms' management, Caesars spent just $3.7 billion or an average of $0.46 billion per year, about 25% of the pre-buyout average annual capital expenditure.[13] And, from 2006 to 2018, Caesars nationally shed 24% of its workforce, going from 85,000 employees[14] to 66,000.[15]

2. The Supermarket Industry

Economist Eileen Appelbaum and Professor Rosemary Batt recently compared the performance of supermarket chains owned by PE firms to those with other ownership structures. [16] Their research shows that the PE investment model leads to riskier capital structures at portfolio companies.

This leverage in turn makes it more difficult for companies to withstand outside pressures - whether from an economic downturn or from changing consumer preferences and technology - and can lead to worse outcomes for employees.

Since 2015, seven major supermarket chains have filed for bankruptcy. These companies employed a combined total of more than 125,000 workers. Some of the blame for these supermarket bankruptcies can be placed on competition from competitors like Walmart and Whole Foods (now owned by Amazon). Another significant factor, however, was the financial engineering of the PE firms who were behind all seven bankruptcies.[17]

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[12] Harrah's Entertainment, Inc., Annual Report (Form 10-K), at 35 (March 17, 2009). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312509055861/d10k.htm.

[13] Caesars Entertainment Corporation, Annual Report (Form 10-K), at 47 (Feb. 15, 2017). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000085833917000039/a2016q4cecform10-k.htm; Caesars Entertainment Corporation, Annual Report (Form 10-K), at 51 (March 17, 2014). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000085833914000014/a201310-k.htm; Caesars Entertainment Corporation, Annual Report (Form 10-K), at 38 (March 4, 2011). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312511056393/d10k.htm.

[14] Harrah's Entertainment, Inc., Annual Report (Form 10-K), at 8 (March 1, 2007). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312507044315/d10k.htm

[15] Caesars Entertainment Corporation, Annual Report (Form 10-K), at 8 (Feb. 22, 2019). *Available at* https://www.sec.gov/ix?doc=/Archives/edgar/data/858339/000085833919000015/a2018q4cecform10-k.htm

[16] Rosemary Batt and Eileen Appelbaum, Private Equity Pillage: Grocery Stores and Workers At Risk, American Prospect, Oct. 26, 2018 *available at* https://prospect.org/article/private-equity-pillage-grocery-stores-and-workers-risk.

[17] *Id.*

PRIVATE EQUITY–BACKED CHAINS THAT WENT BANKRUPT

GROCERY CHAIN	P.E. SPONSORS	NUMBER OF STORES	NUMBER OF EMPLOYEES	BANKRUPTCY DATE
A&P (Food Basics, Food Emporium, Pathmark, Super Fresh, Waldbaum's)	Yucaipa Partners	296	28,500	July 2015
Fairway Market	Sterling Investment Partners	15	4,000	May 2016
Fresh & Easy	Yucaipa Partners	150	4,000	Oct. 2015
Haggen Food Grocery Store	Comvest Group	164	10,000	Sep. 2015
Marsh Supermarkets	Sun Capital	116	14,000	May 2017
Southeastern Grocers (BI-LO, Bruno's, Fresco y Más, Harveys, Winn-Dixie)	Lone Star Funds	>730	>50,000	Mar. 2009, Mar. 2018
Tops Markets LLC	Morgan Stanley	170	14,800	Feb. 2018

Batt & Appelbaum, Private Equity Pillage: Grocery Stores and Workers at Risk

Appelbaum and Batt found that, "private equity owners have extracted millions from grocery stores in the last five years—funds that could have been used to upgrade stores, enhance products and services, and invest in employee training and higher wages."[18] These companies struggled to pay down excessive debt, and ultimately filed for bankruptcy that left workers, suppliers, and other creditors getting the short end of the stick. Employees were thrown out of work and forced to take cuts to their retirement benefits. [19]

[18] *Id.*

[19] *Id.*

In September 2015 Haggen, Inc, a west coast grocery chain owned by Comvest Partners, declared bankruptcy after a failed expansion. According to Applebaum and Batt:

> Workers, vendors, suppliers, and landlords were losers in this story, but not Comvest... At the time that the P.E. firm agreed to buy the 146 stores, securities filings show it also reached a deal to sell the real estate underlying 20 of the new store locations for $224 million—and lease them back under a sale-leaseback agreement. It later engaged in sale-leaseback transactions for additional stores—for a total of 39 stores. Through these sales, Haggen made an estimated total of $300 million according to regulatory filings and real-estate documents—roughly equal to what it paid for the 146 stores… The unsecured creditors meanwhile—mainly laid-off workers, suppliers, and landlords—were owed roughly $100 million.

And in February 2018 Tops Markets declared bankruptcy:

> The northeastern chain of 170 grocery stores was bought out by Morgan Stanley Private Equity and Graycliff Partners in an LBO worth $310 million in 2007. Morgan Stanley pursued a number of LBO add-ons between 2007 and 2012, and then financed the buyout of the company, including all of its debt, by Tops management in December 2013. By that time, Morgan Stanley had loaded the company with $724 million in debt—more than twice the original purchase price. That included some $377 million in dividends that Morgan Stanley paid to itself and its investors—equal to 55 percent of the total debt that had accrued. This does not include advisory fees charged by Morgan Stanley nor the future interest payments that Tops had to shoulder…
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> [T]he debt overhang left Tops with little wiggle room to reduce prices or resources to invest in store upgrades, new products, and online services needed to be competitive, as it reported itself in its bankruptcy filing. At the time of the bankruptcy, it had 14,800 employees... The company used the bankruptcy process to substantially reduce the pension

3. Toys 'R' Us

Toys 'R' Us is another example of a PE-owned company that ended up in bankruptcy. The iconic toy store was purchased by a consortium of PE firms in 2005 for $6.6 billion. Before it was acquired by PE, Toys 'R' Us had $1.86 billion in debt. As a result of the leveraged buyout, Toys 'R' Us was saddled with $5 billion in debt. The company filed for bankruptcy in 2018 despite having $11 billion in annual sales.[20] When the company was ultimately liquidated in bankruptcy, it left 31,000 employees out of work.[21]

Toys 'R' Us' PE owners have blamed its failure on competition from online retail providers, like Amazon, and other market forces. Multiple analysts, however, have said the blame rests to a very substantial degree with the company's unsustainable debt and warned that other retail chains could fail in a similar manner due to highly leveraged PE investments.[22]

Private Equity and Pension Investments

On average, pension plans in the U.S. have allocated 8.6% of their portfolios to PE.[23] In many situations, pension plans are under pressure to make up for insufficient employer contributions. To make up for these shortfalls, pension plans chase riskier investments that could produce greater returns. PE funds advertise that they have the ability to provide those returns. Unfortunately, the opacity, illiquidity and high fees associated with PE add to the risks of the investment and the difficulty in achieving returns sufficient to justify those risks.

A lack of transparency makes it difficult for investors to analyze the accuracy of claims that PE funds outperform other asset classes. The internal rate of return methodology that PE funds have traditionally used to report their performance has come under criticism by Warren Buffet and others for inflating returns.[24] The CFA Institute has explained that typical methods for comparing performance "work well (at least from a statistical perspective) only for those instruments that are publicly traded and are highly liquid. This is a major problem for private equity (PE) investments as they are not only 'private' and illiquid but also exhibit serious smoothing issues because of subjective appraisals and valuation lags."[25]

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benefits for [employees] by withdrawing from [union] defined benefit pension plans and replacing them with 401(k) plans.

[20] Jessica DiNapoli and Tracy Rucinski, *How $5 billion of debt caught up with Toys 'R' Us*, Reuters, Sept. 17, 2017 *available at* https://www.reuters.com/article/us-toys-r-us-bankruptcy-timeline/how-5-billion-of-debt-caught-up-with-toys-r-us-idUSKCN1BV0FQ.

[21] Chris Isidore, *31,000 Toys 'R' Us employees: No job and no severance*¸ CNN, Mar. 16, 2018 *available at* https://money.cnn.com/2018/03/16/news/companies/toys-r-us-employees/index.html.

[22] Dave Dayen, The Cause and Consequences of the Retail Apocalypse, The New Republic, Nov. 14, 2017 *available at* https://newrepublic.com/article/145813/cause-consequences-retail-apocalypse.

[23] American Investment Council, Public Pension Study, May 2018 *available at* https://www.investmentcouncil.org/wp-content/uploads/2018-public-pension-study-final3.pdf.

[24] Hema Parmar and Sonali Basak, *Private Equity's Returns Questioned, This Time by Buffett*, Bloomberg, May 5, 2019, *available at* https://www.bloomberg.com/news/articles/2019-05-05/private-equity-s-returns-questioned-again-this-time-by-buffett.

[25] Prasad Ramani, *Evaluating Private Equity Performance: PME vs. Direct Alpha*, Enterprising Investor, CFA Institute, Jul. 23, 2014 *available at* http://blogs.cfainstitute.org/investor/2014/07/23/evaluating-private-equity-performance-pme-vs-direct-alpha/.

In December 2018, the CFA Institute published a report titled “Private Equity: The Emperor Has No Clothes” that examined different models of private equity returns. It concluded that “Exposure to small caps likely explains private equity returns. Liquid alternatives to private equity can be created simply by buying small, cheap, and levered stocks… [Locked-up capital] keeps investors from redeeming their funds at market lows and helps private equity firms weather storms like the global financial crisis. But the same fund structure can be replicated through public equities at a fraction of private equity fees.”[26]

Investment management fees are also a major problem for PE investors. Compared with other asset classes, PE funds charge high fees that take away from investors’ returns. The typical fee structure, known as “2 and 20,” means that the PE fund manager receives 2% annually of the total amount of assets under management plus 20% of the return on any investment. These high fees enrich GPs while weighing down the investment returns of PE investors.

PE investments are also illiquid, and therefore pose greater risks for investors. The average life of a fund is 10 to 13 years.[27] The secondary market for interests in PE funds is very limited. The total transaction volume in the secondary market in 2018 was estimated at $72 billion.[28] To put that in perspective the industry has around $4.1 trillion in committed capital – less than a 2% turnover rate.[29] Once an investor buys into a fund, it is very difficult to get out before the fund sells off all the companies in the portfolio.

The Dodd-Frank Act required PE fund managers to register with the SEC and to submit to periodic examinations. After the first round of exams, the then SEC Director of the Office of Compliance Inspections and Examinations Andrew Bowden revealed that extensive abuses had been uncovered. Bowden said in a 2014 speech, “When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.”[30] The minimal reporting and examination requirements instituted by the Dodd-Frank Act revealed an industry where abusive practices towards investors were common practice.

Conclusion

Private equity has grown from a niche industry into a tremendous and dark force in the U.S. economy and the lives of millions of working people. Except for the GPs who profit from the PE investment model, the impact PE has on the lives it touches is often a harmful one. There is no

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[26] Nicolas Rabener, *Private Equity: The Emperor Has No Clothes, Enterprising Investor*, CFA Institute, Dec. 3, 2018 *available at* https://blogs.cfainstitute.org/investor/2018/12/03/private-equity-the-emperor-has-no-clothes/ .

[27] Robert Harris, Tim Jenkinson and Steve Kaplan, *Private Equity Performance: What Do We Know? Available at* http://faculty.chicagobooth.edu/steven.kaplan/research/kpe.pdf

[28] Coller Capital, *The Private Equity Secondary Market*, Coller Capital Ltd. 2019 *available at* https://www.collercapital.com/sites/default/files/Coller%20Capital%20%E2%80%93%20the%20private%20equity%20secondary%20market_0.pdf.

[29] *Press Release: Private Equity Industry Grows to More Than $3tn in Assets*, Preqin, Jul. 24, 2018 *available at* http://docs.preqin.com/press/PE-Assets-Jul-18.pdf.

[30] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Spreading Sunshine in Private Equity, May 6, 214 *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.

public interest reason to allow the PE industry to continue carrying on business as usual.

PE executives should pay their fair share in taxes. They should share in the losses as well as the gains of their investments. PE should not be allowed to suck value out of viable businesses and leave workers, pensioners, and communities to deal with the repercussions. And, when PE invests other people's money, the GPs should be required to act in those people's best interests and provide honest information about what they're doing.

This is what the Stop Wall Street Looting Act will do if it is enacted. For too long, public policy has failed to grapple with the abuses of the PE industry. The SWSLA will remedy market failures by aligning the incentives of PE executives with companies, workers, and society as a whole. For these reasons, we strongly support enactment of the SWSLA.