PUBLIC SERVICES INTERNATIONAL

The global union federation of workers in public services

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Ten Tricks:

A SHORT HANDBOOK OF FINANCIAL ENGINEERING

Public Services International (PSI) is the Global Union Federation (GUF) that represents the whole of the Care Sector. Our affiliates represent care workers in the global north and the global south. We fight for the rights and voice of care workers in the private, public and not for profit care sectors and across local and regional government, national government and in the health sector.

We work with global norm setting bodies to fight for the rights of care workers and the provision of care as a public good - not a profit making activity. We are the only Global Union Federation with representative status at the World Health Organisation (WHO). We fight for the social re-organisation of care, care as a human right, and with our affiliates we organise care workers to build their power and voice. We have a strong focus on the women and migrant workers that make up the majority of the care workforce.

Public Services International is a global trade union federation whose affiliates represent 30 million working women and men who deliver vital public services in 163 countries in both the public and private sector. PSI champions human rights, advocates for social justice and promotes universal access to quality public services. PSI works with the United Nations system and in partnership with labour, civil society and other organisations.

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Introduction

Most workers affected by financialisation and Private Equity (PE) intuitively know the game is rigged against them. We have produced this handbook because organising for quality care and decent work, and an end to some of the worst practices in the sector, is not possible without understanding how these tricks work.

This guide describes ten of the most important Private Equity (PE) tricks in simple and accessible terms. It is a companion document, created to provide a more in depth analysis of the financialised techniques discussed in the PSI Report "Care Givers and Takers: How finance extracts wealth from the care sector and harms us all." These tricks are not confined to the care sector, and once workers and unions begin identifying them in the care sector, they will likely begin to see them operating elsewhere.

The guide is also an important resource for care sector workers, unions, patients, families and advocates to help them look out for the tricks and symptoms of financialization as they appear and affect their lives and workplaces. Importantly it will help them understand these effects and look out for them in advance.

The tricks outlined demonstrate the wide array of methods and strategies implemented by financiers to extract wealth from companies for themselves. When such tricks are abused, they can turn perfectly healthy companies into hollowed out wrecks.

But when they are implemented in sectors such as care, where the lives of some of society's most vulnerable people are on the line, the human toll is morally unacceptable.

In this context the guide is critical in dispelling the myth, meticulously shaped and promoted by private sector actors and some in government and the media, that there is an inherent tension between workers interests and patients interests. To the contrary it shows how much is being syphoned out of the system before the workers or patients even know it was there.

Many workers will be shocked by the simplicity and audacity of these tricks. For many more it explains why the companies that seem to always make profits are never able to find the money for them or for those whom they care for. Most workers will be outraged that these tricks are allowed in the care sector when so many workers sacrifice for the care of their patients.

For all, it is a critical first step to organising and fighting back.

WHAT IS PRIVATE EQUITY (PE)?

THE MYTH

A PE firm is typically owned and controlled by a few rich people, often billionaires. They invite other investors (like a trade union's pension fund) to invest into their PE fund, with the promise of high returns. The moguls put very little of their own money into the pot: typically only 1-2 percent of the total.

The moguls then take that pot of investors' cash and use it to buy a company, perhaps a chain of pizza restaurants, a company exploring for oil and gas, a chain of funeral parlours . . . or a company providing social care.

The myth is that the moguls are "wealth creators" who buy up struggling companies, then fix them up, "unlocking value" by turning them into roaring engines of capitalism. That does happen, though often through vicious cost-cutting. But more commonly, PE firms buy perfectly healthy companies, then use financial engineering to extract wealth from all those companies' stakeholders: workers, taxpayers, suppliers, the pension fund, and others.

OUTLINE

You don't need to be a financial expert to understand these tricks: they are all, at heart, quite simple. Visualise each as a drinking straw inserted into a can of fruit juice, to extract the valuable liquid inside. And remember: the main economic value in the care sector – the fruit juice – is provided above all by the toil of care workers.'

For clarity's sake, we describe here the rather extreme versions of these tricks. In reality, PE firms can also carry out beneficial activities (such as borrowing to invest in new equipment) alongside rapacious activities. But this reinforces the key point: the good stuff is what any well-run company would do: the bad techniques outlined here are what PE firms specialise in.

There is nothing inherently illegal about any of the tricks outlined-though any reasonable person might conclude that all of them should be curbed or even outlawed.

TRICK 1: SPECIAL DIVIDEND / GET THE COMPANY FOR FREE

This is bread and butter for many private equity firms. It is sometimes known as the "dividend recap" or "special dividend," and it goes like this.

1. A PE fund buys a company - *HospitalCo* - for $50 million. The moguls now control *HospitalCo*, so they can tell its managers what to do.
2. They order *HospitalCo* to take out a loan for $50 million, and they help *HospitalCo* find people who will lend the money.
3. *HospitalCo* funnels that $50 million in borrowed money straight to the PE Fund, as a "special dividend" or "dividend recap."

Blink, and you may have missed what happened here. The PE Fund has paid $50 million for *HospitalCo* but then received $50 million from *HospitalCo* – in effect, they obtained *HospitalCo* "for free"! And if that now indebted company collapses, they can shrug off the consequences.

It is *HospitalCo*, not the moguls, that must contractually repay this $50 million - plus interest. The complex corporate structure serves as a one-way shield allowing profits to flow up to the moguls but risks and losses to flow down to workers and other stakeholders, who must work harder; in effect to help the moguls buy more châteaux in the Dordogne. The Moguls have made a killing, with little effort. But they can now go further still. They could put *HospitalCo* through the wringer to flush out more profits. Maybe they cut nurse-patient ratios and lay off staff, to save $4 million a year. They use tax havens to cut the tax bill by $5 million a year, using other tricks described below.

As a senior UBS banker put it, they "*keep taking out dividends so they've gotten all their investment back. Then it's just gravy and they just keep re-levering it.*" These "dividend recaps" wax and wane in popularity. The Financial Times reported in September 2020 that after a lull, "*almost 24 per cent of money raised in the US loan market has been taken to pay for dividends to private equity owners.*" For example, Steve Schwarzman said in 2015 that this "dividend recap" trick was an alternative to selling a company for a profit. "*You just sell them if the sales market is good, and if not, you recap them and you make money that way*," Schwarzman told analysts during an October 2015 conference call. "*So we just sort of go with the flow*."

TRICK 2: THE OPCO-PROPCO SHUFFLE

This is a common trick for PE owned companies that have a lot of real estate such as care homes, hotels or hospitals. Also known as "sale and leaseback", it is a way to get bankers to lend more. It's a little more complex, but still pretty simple:

- A PE fund spends $1 billion, say, to buy a healthcare company.
- It splits the company into two main parts: an operating company (Opco) that runs the main businesses, employs the staff, etc.; and a property company (Propco) that owns the real estate assets.
    - Either they sell PropCo to outside investors, in which case some or all of the cash from the sale can be funneled straight to the moguls.
    - Or both OpCo and PropCo stay inside the same corporate structure (controlled by the Moguls). In this case they can engineer a 'pretend sale' where PropCo pays OpCo a large sum of cash, hopefully $1 billion, which the Moguls then siphon off, fully or in part. (Where does PropCo get this cash from? Read on.)
- Either way, as part of the overall deal OpCo signs a long-term lease agreement with PropCo, where OpCo agrees to make regular rental payments to PropCo for renting the properties. Those rental payments are used as a basis either for those outside investors to pay lots of cash for the PropCo business, or for bankers to lend lots of cash to the company.
- OpCo – employing the carers, cleaners and so on – now struggles under $1 billion in rental repayments and interest. It will have to cut costs hard – with real human consequences.
- It may be worse still. OpCo may have had to sign a horrible long-term lease for the buildings, forcing it to make very high rental payments (which may increase rapidly each year.) This promise of very high payments to PropCo make it (on paper) more valuable, whether for sale to outside investors or as a basis for borrowing more: either way, extra cash is obtained which can be sent up to the Moguls. In Australia, for instance, a trust may be used instead of locating the PropCo offshore. The trust is not taxed, so it behaves like an offshore structure in this respect, and this can create tax advantages for shareholders.

A report on the UK care sector in 2019 estimated that of the 26 largest companies providing adult care in the UK, 18 had split property companies from the operating companies. One indicative example involves BMI Healthcare, a company majority-owned by the South African-listed multinational Netcare with 59 hospitals across the UK, which made large losses after signing a swathe of onerous leases in 2006 under the Opco/Propco model. This resulted in a situation where the rental payments rose to a fifth of total revenues.

WELL OVER HALF OF THE UK'S LARGEST ADULT CARE CORPORATIONS USE THE THE OPCO-PROPCO SHUFFLE: A SIGN OF FINANCIAL EXTRACTION.

TRICK 3: WIPE OUT THE TAX BILL

This is another pretty straightforward trick, using loans inside a corporate structure to dodge taxes.

Let's say HealthCo, a well-run healthcare company in South Africa, makes $10 million in profit a year: if the South African corporate tax rate is 28 percent this means $2.8 million a year in tax goes to the South African Government, to help fund public services, such as healthcare.

A PE firm decides to buy HealthCo. The Moguls set up HavenCo, a subsidiary company in a tax haven (which they also own). HavenCo lends $50 million to HealthCo, and charges interest on this loan at a very high 20 percent rate: so HealthCo now has to pay $10 million (20 percent of $50 million) per year to HavenCo.

Before the buyout, HealthCo had profits of $10 million a year, but now it has to pay $10 million a year in interest to HavenCo, leaving zero profits reported in South Africa. With zero taxable profit, the tax bill falls from $2.8 million to zero.

HavenCo, meanwhile, earns $10 million in clear profit from this arrangement (let's ignore any costs, for simplicity) – but because the tax rate in the tax haven is zero, it pays no tax there either. The Moguls own HavenCo, so they can take this $10 million for themselves. In six years, they've made $60 million back, and they're still owed that original $50 million!

Again, nothing useful or productive has happened here: it's simply that wealth has been transferred away from South Africa's Government to the moguls.

This is a variant of a common trick used by multinationals, known as transfer pricing. (PE officials themselves also personally benefit from other forms of preferential tax treatment: but that's another story.)

A report for the UK's Center for Health and the Public Interest in 2019 found that the five largest PE owned care home providers in the UK had borrowed an average of £35,072 for every care bed they owned, generating interest costs of £102 per bed per week. These interest payments represented over a third of all non-staff costs: a massive drain on care resources and a powerful hidden source of pressure on employees and residents.

Some call this 'tax avoidance,' or 'tax optimisation'. However, this can be misleading. As the Scottish comedian Frankie Boyle put it: "If you're rich, don't look at it as tax avoidance. Look at it as a children's hospital buying you a pool table." More generally, a lot of what gets called "tax avoidance" exists in a grey area between legality and illegality.

TRICK 4: USING TAX HAVENS TO AVOID WAGE INCREASES

Take the example above, where HealthCo has $10 million in annual (genuine economic) profits – representing above all, let's not forget, value created by workers.

But now HealthCo has to make $10m annual interest payments to HavenCo, leaving it with zero profits on paper. When union negotiators come to the bargaining table to try and raise nurses' wages, the company will say, technically truthfully, that there are no profits to share around with workers, and send the negotiators packing, empty-handed.

In reality, large internal economic profits do exist which could have been used to improve pay or working conditions, but are instead being siphoned off via HavenCo into the pockets of the moguls before they can hit the (visible) balance sheet. You might call this 'extracting workers' wages out to a tax haven.'

Trick 3 above with debt interest is one example of a siphon: several others exist, such as consultancy or management fees paid to companies controlled by the moguls, large executive compensation packages, dividends to shareholders (Trick 1) rental costs to a "Propco" (Trick 2) and more.

For instance, a 2019 report by the Center for Health and the Public Interest (CHPI) showed that for the 18 largest for-profit providers in the UK care sector, around one third of all non-staff costs were in the form of such "leakages." It is worth noting that these leakages tend to be a lot bigger than just the tax losses.

TRICK 5: BANKRUPTCY FOR PROFIT

This is a less common trick. Essentially, a company is bought, looted into bankruptcy, then bought out of bankruptcy again at a knock-down price.

The reason to do this is that the company before bankruptcy had all sorts of obligations to creditors, to its pension fund, and so on.

Once it is bankrupt, it can throw off those obligations onto the shoulders of public institutions which may have to step in to pay out pensions to workers and so on.

TRICK 6: EXTRACTING FROM OUTSIDE INVESTORS

This is a financier-eat-financier trick - but it's often everyday people at the bottom of the chain who pay the price.

The PE moguls collect Other People's Money (OPM) from outside investors, perhaps your pension fund. They then invest these pots to buy up CareCo and other 'targets,' and financially engineer those targets to extract profit.

In theory, if companies like CareCo and their staff and residents are being milked dry, at least this predation ought to show up as higher returns for those outside investors – such as your pension fund. Right?

Wrong. As mentioned above, the titans extract a range of (often hidden) fees, to help the Moguls pluck those swollen fruits of the predation before those outside investors get their share. These fees – some charged openly by the Moguls to the outside investors, while others are mostly more hidden, charged to the underlying portfolio companies – add up to a staggering seven percent of the value of the fund, each year, on average.

Many of these fees, especially the hidden ones, are not just immoral but would be illegal for companies listed on a public stock market. Even then, there is plenty of lawbreaking. A US regulator who investigated PE said in 2014:

"We have identified what we believe are violations of law or material weaknesses in controls over 50% of the time."

Sentiments echoed by another top US regulator:

"Investors' pockets are being picked . . much of what we're uncovering is undetectable by even the most sophisticated investor."

The website Naked Capitalism, a leading expert site that has exposed many PE malpractices, looked at 12 PE agreements with outside investors, and concluded that:

"The private equity industry's claims that the general partners obey the law are false. Instead, critical elements of their scams and violations of public interest depend on their being hidden from view. The document release also reveals what dupes the investors have been.
. . .
[The secrecy is] a self-serving ploy to shield the documents from scrutiny, since third parties might ferret out how private equity firms increase their already substantial profits at the expense of complaint, clueless investors."

Why do investors get fooled? Because PE firms use a range of other tricks to artificially and dishonestly inflate their fund performance, and to incentivise officials at pension funds to invest with PE. The industry, of course, also 'sponsors' some academics and think tanks to produce wonderful reports saying that they provide fantastic returns for investors. It is imperative for them to promote this story, since their earnings relate to how much OPM they can attract, and this in turn depends on investors believing PE will make them rich.

As Eileen Appelbaum and Rosemary Batt outline in their book Private Equity At Work:

"PE's lack of transparency makes independent analyses of its data all but impossible. . . . reports that PE funds substantially outperform the stock market come almost entirely from industry sources."

An article in the Financial Times summarised a research paper by Ludovic Phalippu from the **Oxford Saïd business school** which "showed these illiquid funds have performed no better on average than a cheap US stock market tracker since 2006. Investors, however, have paid about $230bn in performance fees over the same period, helping to create a new class of super wealthy private equity barons with multibillion-dollar personal fortunes."

TRICK 7: ROLL-UPS AND MONOPOLIES

PE firms often buy multiple companies in the same sector, or market niche, in a 'roll-up', combining them all into a conglomerate which may bring economies of scale, but also may have stronger monopolistic or market power. This power may give the private equity firm the ability to put more pressure on suppliers, workers, or local authorities.

Local monopolies are easier to build than national ones. For example, in 2013 the UK's Competition and Markets Authority (CMA) concluded that large private hospital operators were using excess market power to overcharge patients, and ordered them to sell some off. While there were a large number of players at a national level, five large actors were accused of, as the Financial Times put it, "carving up the country into local monopolies and of striking cosy relationships with doctors and insurance companies that pushed up prices."

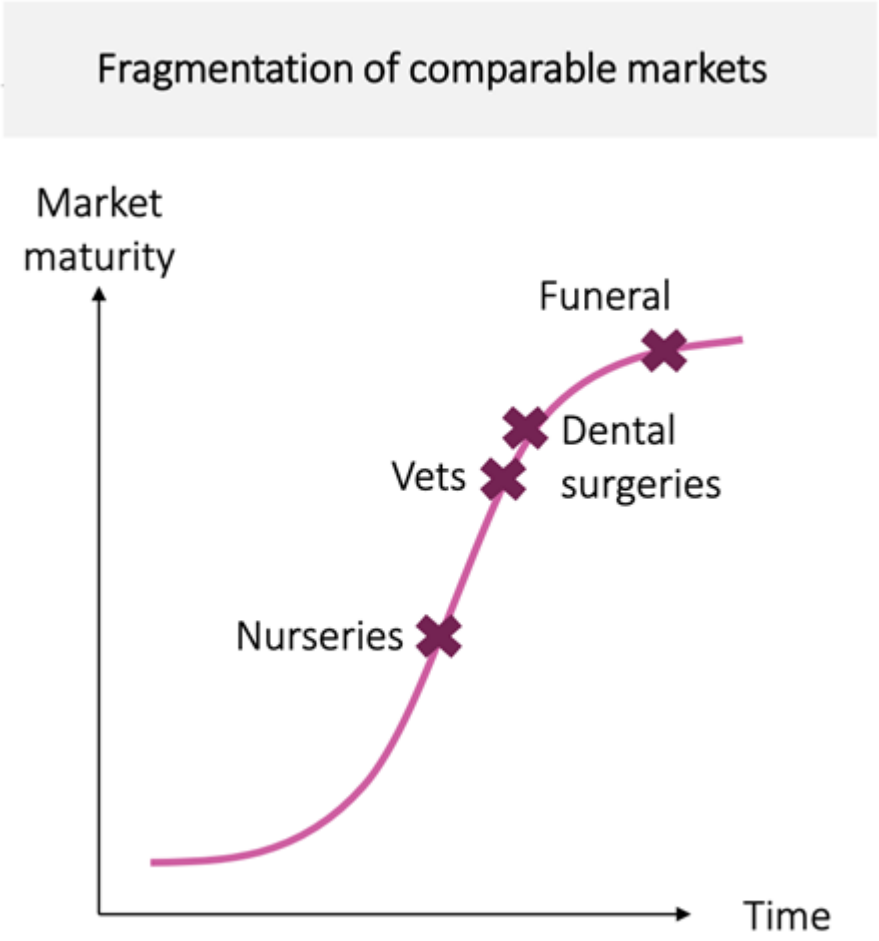
There are other reasons for roll-ups, beyond building monopoly power. Another reason goes back to the analogy made above, where the PE mogul knows that buying a company is like flipping a coin where heads gives him zero profit, and tails gives him large profits: he cannot lose. The more coins he flips, the richer he will become. So he buys as many as possible.

And there is a third reason for roll-ups, as US monopoly expert Matt Stoller outlines:

"Doing a roll-up is designed to take advantage of how capital markets value bigger companies versus small ones, or what is called multiple expansion. Buying a small family owned business for three to four times its cash flow . . . [then] putting it into a conglomerate that financiers then call a 'platform' or 'market leader', means you can often sell the much bigger company for eight to ten times that cash flow later on. "

Graph 1, from a report on the childcare "market" illustrates, how investors see this.

The "fragmentation" displayed by Graph 1 is essentially the opposite of consolidation and monopolisation. It shows that while funeral services in the UK are already heavily monopolised, childcare is not (and thus 'immature'), suggesting large potential for "roll-ups".
None of these three main incentives for roll-ups are beneficial for workers, patients, and wider society. Quite the opposite.



Source: Cairneagle LaingBuisson UK Childcare Market Report 2020

THE EXAMPLE OF SOUTHERN CROSS

One of the best-known examples of this sort of rapid expansion was Southern Cross care homes, a firm set up in 1996 by a North Sea oil magnate that went on a massive acquisition spree, at a time when financial institutions were arguing that the whole sector needed to "consolidate" – not least, to gain monopolistic power. Southern Cross went through several owners – to West Private Equity, Blackstone, and then a stock market listing. Each owner piled on more financial pressure, and it collapsed in 2011 under heavy debts.

TRICK 8: THE CREDITOR HIERARCHY

Any PE company will have a range of different creditors – people or institutions that it owes money to: not just banks that have lent it money, but also tax authorities, suppliers, pensioners, or workers owed a paycheque.

If a company owned by a PE firm gets into financial trouble or goes bankrupt, then creditors as a whole are unlikely to see their loans repaid or paid in full. When this happens a hierarchy of creditors will crystallise, with some at the front of the queue to recover assets, and others at the back. This hierarchy is written into the fine print in contracts, under applicable laws.

It will not be hard to guess where the moguls stand in the queue, and where the workers and pensioners usually stand, in this hierarchy. (Clue: they are usually at opposite ends.).

When assets are recovered (e.g. equipment is sold) on behalf of creditors, the "secured" creditors get first dibs. Once these privileged financial players – the "senior" creditors, in the parlance, are repaid, and if there is anything left over unsecured ("junior") creditors will get a share.

A related tool here is "shareholder loans" or "loan notes," where the moguls lend money to the company they own, then charge high interest rates, often 10 - 15 percent per annum, and sometimes more. They make money directly from these exceptionally high interest rates (which they usually don't charge as immediate cash but instead just add to the loan value, which therefore grows rapidly). These loans may be high in the creditor hierarchy: so the moguls stand at or near the front of the queue when it comes to getting their money out, whether in bankruptcy or through "exit" (such as sale to another group of investors.)

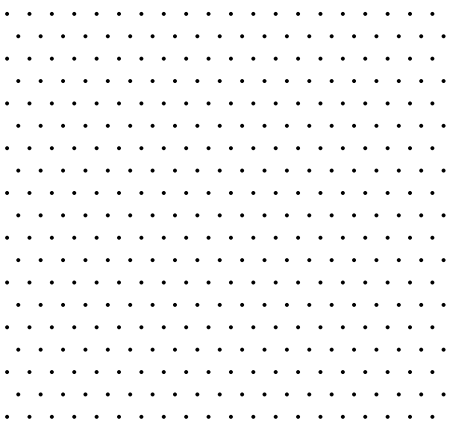
This is a reason why we often find "related parties" to a private equity firm (those related parties are often the moguls themselves) lend to companies inside the complex corporate structure: it means that – alongside tax and other advantages – they often get the first cut when things fall apart.

TRICK 9: SECRECY, TAX HAVENS AND DIRTY MONEY

The more OPM the moguls can get into their funds, the more fees they can charge and the more coins they can flip. One fruitful source of OPM is dirty, looted or criminal money. Private equity firms and hedge funds in the United States, for instance, have been called "a back door into the US financial system for criminals and kleptocrats the world over."

Nobody likes to be publicly associated with dirty or tainted money. So rather than openly attracting dirty money from wealthy criminals, looters or fraudsters, PE moguls collect this dirty OPM first into "feeder" funds parked in tax havens like the Cayman Islands (for those investing in the United States) or Ireland or Luxembourg (for those investing in Europe.)

These tax havens do not just provide tax advantages: they can also be used to create secrecy. A secrecy law in Cayman, for instance, can send people to jail not just for divulging secret information, but also merely for asking for it. So the money flows into the tax haven, gets veiled in financial secrecy, and is then passed on into the target country as anonymous "fund money," no questions asked. Tax havens also tend to have highly lax legal systems: PE firms there can write egregious and opaque contracts without falling foul of local laws.



TRICK 10: EXIT FOR PROFIT

PE officials often appear obsessed with the idea of "exit" - that is, if they buy a care home company, say, will they be able to sell it on later at a profit, whether to another set of PE investors, or to investors on a stock market? The PE world is constantly seeing "deals" where one set of investors buys or sells to another set, often just a short time later, and often because the buyer can see ways to squeeze out even more money, often by finding ways to load on even more debt than before.

According to market intelligence firm Pitchbook, PE had undertaken 64 nursing and retirement home "deals" in the UK since 2010. Each "deal" usually involved a number of care homes. Often, staff have no clue what is happening, above their heads, or the pressure that additional debt is likely to bring.

A private equity boss said pressure from investors looking to "exit" after five or six years translates into pressure on home operators to focus on short-term results and scale back operations, harming long-term viability. "It cripples them."

In the words of Sameer Rizvi, CEO of RD Capital Partners, a healthcare-focused buyout firm that owns several facilities:

"Some nursing homes change hands two or three times and it cripples them. It doesn't work if investors go into the sector looking to exit after five years and they end up doing foolish things to make good returns."

Rizvi added that the pressure from investors looking to exit after five or six years translates into pressure on home operators to focus on short-term results and scale back operations at the expense of long-term viability.

Remember: even if exit is impossible or the firm goes bankrupt, the titans have often made large profits already, so a happy exit may merely be icing on the cake for them.

For further information on how to tackle financialisation and strategies and solutions for change, see section three of this handbook's companion document: "Care Givers and Takers."

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