

NOTES AND COMMUNICATIONS

PRIVATE EQUITY AND SHAREHOLDER ACTIVISM: SUMMARY OF THE 2007 ANNUAL MEETING REPORTS OF THE ROYAL NETHERLANDS ECONOMIC ASSOCIATION

Summary

This Communication is a summary of the 2007 Annual Meeting Reports of the Royal Netherlands Economic Association. It draws a few policy conclusions in relation to private equity, hedge funds and shareholder activism in the Netherlands. This richly varied collection of the 2007 reports and columns of the Royal Netherlands Economic Association adequately reflects the diversity of analyses and opinions on private equity, hedge funds and shareholder activism in the Dutch society. How the balance in corporate governance will be restored is something that cannot be determined precisely at this moment. However, the reports and columns in this collection contain many good and interesting recommendations that can serve as guidelines for academics and policymakers.

Key words: Private equity, hedge funds and shareholder activism

1 INTRODUCTION

In this Communication we try to summarise the 2007 Annual Meeting Reports of the Royal Netherlands Economic Association (*Koninklijke Vereniging voor de Staathuishoudkunde, KVS*) and draw a few policy conclusions in relation to private equity (PE), hedge funds (HF) and shareholder activism in the Netherlands. We give our interpretation of the various reports, and hope that in doing so we do not undermine the conclusions drawn by the authors of the reports themselves too much. We leave the interpretation of the stimulating columns by Henk Brouwer, Paul Koster, Lex Hoogduin, Ieke van den Burg and Menno Tamminga, which often support the conclusions of the reports, to the reader themselves. In our policy conclusions we follow the sequence of the reports and concentrate on a number of themes, which we believe constitute the real choices for policymakers. However, we have no pretension that our policy conclusions will do complete justice to the wealth of the reports and columns that make up this collection. We therefore encourage the reader to read the entire collection; the quality of the various contributions justifies this.

2 THE BOOT & COOLS REPORT

In their report, Arnoud Boot and Kees Cools assert that the central question today is how the function of public equity can be strengthened in the Netherlands. Activist shareholders and private equity should in their view be seen primarily as repair models and less as a long-term solution for the public equity model. Activist shareholders (hedge funds) strengthen the public equity model by accommodating its inherent weaknesses, such as lack of management discipline and free-rider issues. Generally, Boot & Cools see shareholder activism as a healthy development, which can prompt companies to engage in a better dialogue with shareholders and other stakeholders. In addition to benefits, however, it also brings drawbacks because the immediate actions for which activist shareholders often call may be at odds with principles of prudence and long-term value creation. Once shareholders become activists, a company management has generally lost its credibility with the financial markets. A direct consequence is that this management has insufficient credibility to obtain a mandate for a long-term strategy; management is then left with its back to the wall and a long-term view becomes virtually impossible.

Private equity not only offers an alternative by removing companies from the stock exchange via buyouts, but also gives shareholders information and power, and consequently the ability to create focus and discipline. Here again, however, there are a number of drawbacks. The actions of private equity players are usually temporary in nature because after a few years they begin looking for an exit or sale. In addition, this model is also not without cost and can also lead to perverse incentives. Private equity has a relatively short time horizon and an almost exclusive focus on improving financial returns. For both activist shareholders and private equity, Boot & Cools have formulated a number of recommendations to compensate for these potential drawbacks. These recommendations are greater transparency regarding the financial interests of the various stakeholders, better rules of conduct for the bidding process, the ability to deal in shares and a clearer position and responsibility for the Supervisory Board.

Boot & Cools also call for the direct strengthening of the public equity model. They see two complementary and more direct solutions: strengthening the Supervisory Board and strengthening the stability of the shareholder structure. This, they argue, should make it possible for the Supervisory Board to gain a better grip on both management and shareholders, creating scope for a better dialogue and more stable strategy. The combination of a Supervisory Board that is too remote and inactivity on the part of widely dispersed shareholders leads to inadequate supervision of the company in the formulation and implementation of its strategy. The activist shareholder demands more of the Supervisory Board, which must be more closely involved in the day-to-day operations of the business, especially in relation to strategic issues

and implementation of the main lines of policy. The more aggressive climate in which listed companies now operate thus demands active involvement in the strategy by the Supervisory Board, without sacrificing the Supervisory Board's independence with respect to management. To achieve this, Boot & Cools recommend a drastic reduction in the average age of Supervisory Board members and a greater diversity of membership, to enable them to fulfil their new role more effectively, and even speak of a minor earthquake in the Dutch corporate landscape.

Boot & Cools argue that one way of reinforcing the desired stability among shareholders would be for companies to attract more stable minority shareholders. Stock market listing can go hand in hand with having a number of minority shareholders in addition to a free float. The large amount of money that is available for private equity could open the way, via new-style venture capital companies—as a sort of ‘bank’ for shareholders’ equity—for minority interests. This would offer greater stability for the company and its strategy. The authors would also welcome the arrival of a ‘new’ private model outside the stock market, based on financing by venture capital companies through minority participating interests, akin to family businesses but without the specific historical background that characterises such businesses.

3 THE FRIJNS & MAATMAN REPORT

Jean Frijns and René Maatman see a number of weaknesses in the private equity governance system, which in their view require improvement. This applies in particular for private equity, which is concerned with leverage buy-outs (LBOs) of both listed and unlisted companies. In theory, such buyouts are primarily a transaction between shareholders, in which the management of the target company need not play a dominant role. In practice, the situation is different; in many cases, the management of the target company is involved in the transaction at an early stage, because the acquiring party has an interest in making a ‘friendly’ bid and because the management then commits itself at an early stage to the success of the acquisition. The LBO radically changes the strategic framework for the business and can therefore have far-reaching consequences for other stakeholders such as minority shareholders, employees, creditors and customers. According to Frijns & Maatman, there is little point in trusting the incumbent management to make a careful weighing of interests: the directors all too often have a vested interest in the success of the acquisition. The question is how this imbalance can be rectified and how the opposing forces can be marshalled in such a way as to ensure that all interests are properly weighed.

Greater transparency in public bids is a first prerequisite. New regulations, which among other things require that change of control clauses be made public would be a step in the right direction. In addition, there could be

greater accountability vis-à-vis the employees of the party to be acquired. Frijns & Maatman also see a bigger role for the Supervisory Board, for example by demanding that certain management decisions should require Supervisory Board approval, thus increasing the involvement of the Supervisory Board at an early stage. Frijns & Maatman also see great merit in the introduction of appraisal rights into Dutch legislation. They argue that this could serve as a form of discipline for management and could have a corrective function if management has neglected the interests of outside shareholders. They recommend that employees be involved at an early stage in the sale of 'their' company. Greater interplay could perhaps increase the effectiveness of the powers of works councils and trade unions.

More attention needs to be given not only to the acquisition process itself, but above all to what happens after the acquisition. Frijns & Maatman cite the example where private equity firms have adopted an aggressive approach to the sale of business assets and to the relationship between shareholders' equity and borrowed capital. This suggests that the internal controls may need to be improved. Frijns & Maatman call for companies to be subjected to more stringent 'post-LBO' requirements as regards transparency (accountability) and supervision. They propose a study to ascertain whether the disclosure requirements for listed companies could be extended so that they are also effective 'post-LBO'. They also recommend making it mandatory for acquired companies to maintain a Supervisory Board with a majority of independent members. An explicit part of the Supervisory Board's task should be overseeing the healthy financial structure of the portfolio undertaking.

Finally, Frijns & Maatman observe that the governance of private equity firms or partnerships, and the management of the inherent principal-agent problems, should be based less on structures and more on parallel interests and reputation. The rise of megafunds, the introduction of Permanent Capital Vehicles (PCV) and private equity undertakings means that more attention needs to be given to structures with sufficient internal safeguards. In their view, this is most likely to happen in private equity firms that focus on institutional investors. According to Frijns & Maatman, these players would accordingly do well to investigate whether they could take the management of private equity into their own hands in order to head off potential conflicts of interest.

4 THE PAAS, DE JONG, WOLTMEIJER & HAZENBOSCH REPORT

According to Paas, De Jong, Woltmeijer and Hazenbosch, there is an imbalance between the interests of capital providers and the interests of employees, whereas in their view such a balance is needed. This requires a number of elements in the top structure of companies to change, particularly in relation to the tasks, powers and appointment of the Supervisory

Board. The business community is becoming more and more international, and according to these authors this means that national regulation alone is no longer adequate. Paas et al. accordingly argue that European regulation of these aspects is needed.

In the view of the authors, employees have a direct interest in strategic decisions taken by the company, because it is they who will undergo the consequences of the company policy pursued. As a result, the interests of employees should count just as much as those of shareholders. This goes further than good social plans and even further than a proactive social policy. Genuine employee participation, which results in the interests of all stakeholders becoming an essential part of the weighing of interests, is of vital importance. Current practice, in which employees are simply the object of the strategic decisions that affect them, deviates widely from this envisaged situation. Paas et al. realise that the quest for a balance between the interests of shareholders and the interests of employees is probably eternal. They concede that their fundamental choice in favour of a social market economy already embraces so many tensions that perpetuation of the negative situation is guaranteed. It is clear that the quest for balance raises more questions than it answers. For example, how does the participation by the Dutch employees of a multinational compare with the participation of others? And what do governance regulations imply for the competitive position of the Netherlands as a home for business? However, just because the field of private equity and shareholder activism is full of pitfalls, this is in the view of the authors no reason to avoid it; difficult fields can also be rendered productive. With this in mind they argue that the plough must first be turned to our own field, in our own country, based on the idea that a good example will bring its own followers.

5 THE VAN WITTELOOSTUIJN REPORT

Arjen van Witteloostuijn argues that there is a paradox with hedge funds and private equity. On the one hand, he asserts that the 'stringent neoclassical logic', which dominates the economic sciences, leads to a suspicion that the effects of modern expressions of shareholder activism, including those operating via activist hedge funds and private equity, are positive. Not only do hedge funds and private equity generally generate healthy returns themselves, they also make the target companies operate more efficiently and more effectively. Hedge funds and private equity firms fail with some regularity, or else their target companies do. In the author's view, however, these are merely the exceptions that prove the rule. The rise of modern shareholder activism is a primarily positive phenomenon because of the preventive effect it has in the business community as a whole. Van Witteloostuijn argues from the basis of his organisational theory analysis of shareholder activism that there are

also reasons for doubt. The short-term benefits of current shareholder activism may in his view possibly be overshadowed by the long-term costs due to the unnatural profile and rhythm of the change that is imposed on the target companies. Because the long term is generally beyond our view, however, he argues that the word 'possibly' cannot be replaced by 'certainly', 'never' or a conditional clause. Van Witteloostuijn also presents an organisational theory analysis of the potential effects of hedge funds and private equity on the long-term performance of target companies. He concedes that the evidence for the suggested relationships is thin and usually at best indirect. His proposed organisational theory analysis is accordingly above all a research agenda. On the one hand he believes that the theory needs to be further refined; he particularly stresses the need for a contingency perspective: under which circumstances is it likely that the involvement of hedge funds and private equity will have a negative, neutral or positive effect on the long-term performance of the target companies? On the other hand, he argues that there is also a need for empirical investigation; the absence of systematic empirical research means there is still a lack of evidence for many of the suggested relationships.

6 CONCLUSIONS

The debate on the consequences of private equity and shareholder activism will continue for some time to come. This richly varied collection of the 2007 reports and columns of the Royal Netherlands Economic Association adequately reflects the diversity of analyses and opinions on private equity and shareholder activism in our society. Precisely how the balance in corporate governance will be restored is something that cannot be determined precisely at this moment. However, the reports in this collection contain many good and interesting recommendations that can serve as guidelines. We hope that policymakers, politicians and scholars will take careful note of the analyses, opinions and policy conclusions they contain, for the benefit of the Dutch economy and society.

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