Translating Private Equity in Denmark

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Abstract

This paper investigates interactions between the Danish institutional environment and the increasing importance of a relatively new way of financing and controlling firms in Denmark, the private equity industry. We show that private equity firms in Denmark have been simultaneously subject to divergent and opposed pressures emanating from the logic of the private equity field and the national institutional environment. On one hand private equity firms in Denmark operate in a still predominantly coordinated market economy, on the other, they control acquired firms from a managerial perspective, originally imported from liberal market economies. This places in tension contending business systems logics and places in question the private equity field's legitimacy, or its ' license to operate' in terms of the Danish public and polity. We investigate how private equity firms resolve countervailing institutional pressures, which emanate from the friction between a universal model and its local translation and in so doing contribute to the on-going debate concerning the transformation of the Danish model under conditions of contemporary globalization.

Introduction

Private equity firms play a substantial role in advanced economies and an increasing role in developing economies. One of the world's largest private equity firms (PEF) , Kolbert Kravis and Roberts indirectly employed 560,000 people in the United States in 2007 rendering it the second largest employer in the country, just behind Wal-Mart. Mckinsey include the business amongst four new power brokers in global capital markets. Private equity controlled 5% of the value of companies listed on stock markets in the United States, 3% of those in Europe and approximately 0.5% of US$167 trillion global capital market [1] indicating its growing significance over time. Data from the Danish Economy and Business Ministry points to the fact that in 2009, PEF employed 6% of the Danish labor force. 63% of companies acquired by PE belonged to the manufacturing sector, while the service sector accounted for the greater number of jobs among the acquired companies. According to the DVCA annual report, in 2011 Danish companies owned by the PEFs employ 584,000 workers globally. Of these 49,000 employees are located in Denmark, a decreasing proportion. Not only TDC, but other important flagships of the Danish economy such as ISS, Falck and Copenhagen Airport are owned by PEFs.

The chapter does not focus on the performance of PEFs nor seek to offer a performance evaluation. Instead, we examine how institutional heritage, or, different nationally bounded administrative heritages [2] impact upon the processes through which imported business strategies disrupt, attain or maintain legitimacy. The aim of this chapter is therefore to investigate legitimacy dynamics catalyzed by a relatively new way of financing and controlling firms in a business system, which has been considered as a coordinated market economy (CME). We show that PEFs are under pressure to satisfy divergent

expectations simultaneously so as to achieve external legitimacy, or 'a license to operate', in different countries and business systems. We investigate how PE resolves countervailing institutional pressures, which emanate from the friction between a universal model and its local translation. In turn, we explore how local actors are affected by the actions of foreign PEFs, and how these local actors respond. To do so, we explore the acquisition of TDC by a transnational consortium of PEFs.

Private Equity: optimal global benchmarking or financialized capitalism

Private equity employ heterogeneous strategies in managing their acquisitions. Depending on the skill set within the PEF, the economic characteristics of the markets or sectors in which PEF operates and broader macro-economic conditions, particularly liquidity conditions in global financial markets, a private equity fund can easily switch focus, temporal horizon and management strategy. We therefore note that it is incomplete to equate one such strategy with PE in general. However, this chapter focuses on the strategy of the LBO. PEFs engaging in LBOs, or debt-fuelled acquisitions, solicit investor funds and deploy debt to buy mature firms and take them out of public ownership. This is distinct from venture capital funds which provide seed money for immature and usually high tech firms with highly uncertain prospects. By re-engineering the acquired firm's finances and restructuring its operations, PE aims either to return the firm to public ownership through an initial public offering or sell the acquired firm on privately at a higher price. The private equity firm manages acquired companies over a limited period of two to seven years. After this period, any profit is distributed between the firm, the general partners, and the investors, the limited partners, who constitute the private equity fund. Both PEFs and private equity funds are usually Limited liability Partnerships, protecting managers and investors from responsibility for the full cost of any losses incurred within their acquisitions. Each fund is time limited and investors commit a sum at the beginning of the fund's existence, which they must divulge to the firm as and when requested. Solicited capital is most often deployed in the first two or three years of the fund's life. The PEF revenue arises from two sources. First, the firms charge investors approximately two percent of invested funds annually for management services. Second, the private equity firm has been entitled to twenty percent of profits after reaching a 'hurdle rate' usually set around eight percent of invested funds. While the financial crisis has led in some cases to the renegotiation of this contract terms, this remains the dominant model.

Detractors claim PEFs are secretive asset strippers who engross short term and outsized profits by loading acquisitions with debt, systematically reducing tax liabilities and restructuring employment relations along neoliberal lines [3, 4, 5]. In this view, PE generates a dangerously leveraged exposure to firm performance by concentrating equity and increasing the role of debt in the acquired firm's financial structure. On the other hand, proponents of PE hold that PEFs force economic upgrading, increase competitive capacity, promote innovation, create employment and ameliorate the weaknesses associated with the public corporation. Following Jensen [6, 7]. supporters argue PE is an optimal resolution to the problem that owners are separate from the point of control and managers are inadequately incentivised to maximise returns to ownership and in so doing, maximise the efficiency and thereby social utility of the firm. PE corrects market prices by identifying and rectifying the undervaluation of assets and resolves the problems associated with the separation of ownership and control management focus. Further, the specialized and sophisticated skills a PEF will bring to bear in managing an acquisition enable PEFs to impose global best practice within acquisitions. PE is in these terms necessarily a force for good. Our interest here, however, is not so much to evaluate the claims within, or adjudicate on, this debate. Our aim

is to understand the implications of the construction and maintenance of reputation and legitimacy for institutional dynamics and change in a national business system. The dichotomous nature of the debate surrounding PE provides a suitable context in which to meet this challenge. We argue that it is how legitimacy is negotiated that defines institutional enactment and change in this case.

Private Equity in Denmark

Denmark has been widely understood as a clear exemplar of a coordinated market economy [8], where, among other features, broad participation in decision-making has been an important component of national industrial regimes. While Denmark has liberal labour market characteristics, such as low levels of employment security (the famous 'flexisecurity system'), the Danish business system is typified by a strong trade union movement and a tradition of cooperation between labour market actors [9]. An agreement establishing cooperation committees was established in Denmark as early as 1947 by the labour movement and private employers' associations. Firms are embedded within networks of trade and industry associations and engage these associations to solve a variety of incomplete contracting dilemmas and create important non-market collective goods. Organizational power is dispersed across various stakeholders on the supervisory board, and most decisions are consensual [10,11]. A number of legal provisions encourage owners to develop long-term, relational contracts with investors in which a stakeholder system - various groups of employees in addition to owners are given a strong voice in firm management.

On the face of it, these features are at the odds with the PE model, in which, for instance, private equity management are assumed to be able to make frequent and significant changes to acquisition strategies, structures and practices without reference to consensual decision making procedures as would be expected in the typical governance regime of a CME. Crucially, in this market environment the conduct of ownership is assumed to be circumscribed by a host of national institutional complementarities in the interest of long term, socially embedded competitive optimality. In contrast, PE evaluates assets in terms on a global gauge and raise the spectre of Veblen's pecuniary definition of modern business civilisation wherein the differential advantage of capitalist managers (mere 'money capitalists') 'took precedence over the economic advantage for the community; or rather the differential advantage of ownership is alone regarded in the conduct of industry under this system.' [12]. This chapters aims to understand how these two very distinct logics are enacted and negotiated locally.

Methodology and Data

The research focuses on the phenomenon of the acquisition of Danish companies by PEFs. The research is case study based. The example here involves an in-depth case study, covering the period from the initial privatization of TDC through it acquisition by the PE consortium, Nordic Telephone Company (NTC), to its partial re-sale in the 2010 equity sale. Case studies permit a deep exploration of how the institutional contexts in which PEFs are embedded impact on the way they are controlled and coordinated, and, in turn, how the way PEFs control and coordinate the impacts generated by the POE field upon the specificities of the institutional context and its social foundations.

Data were collected using three techniques: (1) semi-structured, one-to-one interviews, (2) semi-structured group discussions, and (3) written and electronic documentation. Informants were chosen according to guidelines for 'purposeful sampling' [13] using a 'snowball or chain sampling' strategy. In other words, the authors chose

informants who would be most able to inform on the main research question concerning changes in legitimacy over time on the basis of auto-description within a discursive field.

Destabilizing Private Equity

The narrative of the TDC case starts with the agglomeration of regional telecoms by the Danish parliament in 1990, which created a single telecoms giant. Like many state owned entities during the 1990s, Tele Danmark A/S was fully privatised by 1998. Given the then prime minister's later central role in opposing the private equity business first in Denmark and then across Europe, it is ironic that Paul Nyrup Rasmunsen was the prime minster during this process, and the wave of privatisations during the 1990s. This initial privatisation opened up the possibility for PE to impact upon the Danish system. Large corporate assets previously considered, and nurtured and protected as, national champions became subject to a global market place. The point of analytical interest here is that as noted above at the core of institutional theory lies the notion that institutional constellations impose an endogenous logic of path dependence on actors who drive and interact with institutional transformations [14]. Relationships between institutions within an institutional environment such as Denmark will often constrain change and, where there is change partially define that change. In this case, however, the actions of rule-makers generated outcomes quite different from those intended. Privatisation in Denmark was intended to create an ownership democracy, not to open up the possibility for what some would subsequently understand to be the disembedding or dismembering of a national champion via an alien business model. This sentiment has been reflected both in the political discourse surrounding the buy-out, but also in the academic literature where there is a claim that firms that constitute the infrastructural architecture of a nation should not be exposed to the full force of the global market. On this basis, we claim that the literature on institutional change needs to be sensitive to the fact that while institutions evolve along path dependent lines, this evolution is marked by a substantive element of contingency. Rule followers may enact institutions in ways in which the results differ markedly from those originally expected. The case here demonstrates that while extant institutional constellations do constrain change, the path of transformation is not pre-defined and actors seeking to control the path of change will often not be entirely successful.

Subsequent to the full privatisation of Tele Danmark A/S, SBC, an American firm specialising in the telecoms sector, bought 42% of the company's shares. In 2004 SBC sold their holdings on the Danish and New York stock exchanges. At this juncture, and in direct reflection of the importance, noted above, attached to TDC as an infrastructurally significant and central component of the coordinated model of Danish capitalism, TDC's 'charter' was amended so that no single shareholder could own more than 12% of the firm's equity. Since PE had at this stage only just emerged on the public radar, it seems likely that this change reflected a proactive defensive move. In 2004, an offer to buy the firm made by the US PEF, Blackstone was rebutted. Subsequently, the company Board removed the restriction on ownership concentration, which opened up the possibility of a PE led acquisition.

In 2005 TDC received a buy-out offer of US$76 billion, or US$382 per share. The offer provided a 'control premium' to existing shareholders of 44.7% over the prior three-month average. The bid was led by NTC, a consortium with a regional focus set up by five giant foreign private equity funds: Apax, Permira, Blackstone, Providence and Kohlberg Kravis Roberts & Co. The Danish pension fund ATP, one of the larger shareholders, rejected the offer, blocking the 90% threshold necessary to compel remaining shareholders to sell. "*For a very long time we had been very critical of the way the board managed the company. In our opinion there was a lot of low hanging fruit at the company. In that respect we didn't think the offer... reflected the possible value of the company. In that way it was strictly an*

investment decision. It made a lot of fuss internally" (PF Director). Consequently, TDC was not taken into private ownership and was subject to the usual reporting requirements for listed companies. Ultimately, Nordic Telephone Company secured an 88.2 percent stake in the fourth largest European buy out to that date.

In 2005 TDC had more than 13 million European customers and was a typical case of a diversified firm theoretically undervalued in the equity market and, given that it was previously state owned, financial market conditions and dominant trends in corporate governance, ripe for restructuring. TDC was widely considered a national champion, which operated as a quasi-monopoly in the Danish telecoms market and was characterised by a corporate governance regime associated with the coordinated market economy. For instance, according to union representatives interviewed, the initial takeover of Tele Danmark by SBC in 1998 led to a situation when the new American owners were unable to understand the specificity of Danish labour relations with its emphasis on co-determination.

NTC's strategy in the acquisition and restructuring of TDC incorporates many of the elements commonly associated with the negative perception of LBOs; leverage, gearing, equity concentration, tax optimisation, asset sales, large managerial fees and remuneration, initial reductions in employee numbers and the redefinition of employment contracts. Consequently, a vociferous debate emerged at all levels of Danish society concerning the legitimacy and consequences of the new ownership model. This debate, reflecting a European wide concern, has maintained its intensity over time as the restructuring and exit strategy unfolded amidst at first a liquidity glut, a surfeit of cheap money, and then the global financial meltdown. Interestingly, the most notable protagonist in this debate has been the former Prime Minister, Poul Nyrup Rasmunsen, who, as noted, had been in office during the TDC privatisation process, but has vehemently and consistently campaigned against the consortium and the PE business model, while pushing at the national and regional level for greater regulation over the industry.

The important point in this context is that TDC, which may not be representative of the activities of PE in Denmark more broadly, was the catalyst for a vociferous public debate over PE in Denmark. What is significant is that the debate concerning PE in Denmark has very much been delimited and defined by the case under scrutiny. Indeed, the private equity business model existed in Denmark well before NTC's takeover of TDC, but the question of the legitimacy of the business model only arose in the wake of the TDC buy-out. TDC placed the private equity business under the limelight.

Significantly, public concern over the fact that TDC had quickly moved from being a major source of corporate tax revenue to paying close to nothing in taxation to the Danish state generated a, at least symbolically, significant change in the taxation of PE in Denmark. As a result of a reduction in tax revenue from seven large companies of two billion Danish Krone, a liberal government reduced the deductabiilty of private equity fund interest payments. The main source of the difficulty lay in the fact that the acquisitions by PEFs were afforded tax deductions on interest rate payments arising from debt incurred in the buy-out, while interest payments from the acquired firm, which theoretically compensate for deductions, flowed out of the country where the Danish tax authorities have no jurisdiction. This phenomenon is extenuated in relation to foreign PEFs. According to the Danish tax authority legal change was enacted specifically in reaction to the case of TDC, which from one year to the next moved from being one of the most important contributors to Danish tax revenues to making virtually no contribution at all.

On the face of it this amounted to a critical challenge to the success of the private equity model in Denmark more broadly, as the tax change impacted not only on NTC and TDC, but Danish PE more broadly. At this juncture the industry, led by the largest and longest standing PEF Axcel, bolstered the role of the industry association, the DVCA. The

main focus of this body was to legitimise PE across Danish society. A DVCA employee stated:

Interviewees employed in the PE business or related financial institutions consistently contrast the strategies of PEFs with features of a coordinated economy and draw parallels between PE and capitalism, and opposition to private equity and socialism or regressive political control. This discourse is firmly situated in a particular, and de-institutionalized, conception of economics, the economy and economic assets. Each is understood as necessarily apolitical, the proper subject of 'scientific' evaluation, and naturally unfolding outside of historical time. As such institutional transformation in any society follows a universal logic emanating from the exigencies of the global market. When confronted with common criticisms of the industry the DVCA respond; "*Yes exactly because there is some argument against capitalism. It is also an argument against … who made a lot of money.… It is not an argument against private equity, it is an argument against capitalism*."

Notably, arguments against private equity did not rest purely on a negative evaluation of the ethics of certain practices and strategies; competition equally mattered. Players in other industrial sectors argued that they were placed at a tremendous disadvantage vis-a-vis PE in regard to their chance of attracting risk capital. In so far as PE was able to gain a differential advantage in terms of financing techniques and related fiscal exposures, traditional industrial players in the Danish institutional environment were placed at a structural disadvantage. Our interviews confirm that industrial players felt at such a disadvantage.

The PE sector, which had existed for almost two decades in Denmark, suddenly became the subject of intense debate over its legitimacy as a direct consequence of the NTC acquisition of TDC. In this context, the perception that PEFs threatened the "Danish model" spread rapidly through Danish society. A critical mass in favour of intervention and greater regulation emerged across different parts of society so that even the liberal government became inclined to impose more exacting regulation on private equity. Figure 1 shows the extent to which the evolution of the number of articles in the Danish media dealing with the issue of private equity mirrors the chronology of the TDC buy out. This demonstrates the catalytic role of the TDC buy out and how this case circumscribed patterns of institutionalization in, and institutional dynamics surrounding the field of PE in Denmark.

The possibility to deduct interest from tax payments had been commonly utilized by Danish PEFs. However, the sheer size of the deduction in the case of TDC generated no less than outrage amongst the public. As a result of the consequent reduction in tax revenues and growing public pressure, a liberal government reduced the deductibility of PE interest payments. Table 1 presents the legislative changes enacted in Denmark as a direct consequence of the TDC LBO; the law from 2007 is known as the 'TDC law'.

Table 1: Legislative Changes targeting private equity:

Year	Effects of law changes
2007	Reduction of tax deductibility of interest payments
2008	Broadening the classification of taxable companies
2009	Eliminating the differential treatment of capital gains and income tax for private equity employees

Source: Danish parliament and tax ministry http://www.ft.dk/ https://www.retsinformation.dk/

As a direct consequence of the debate surrounding the buy-out of TDC, legislation was enacted designed precisely to corral the activities of PE in Denmark and reduce the

ability of PEFs to enjoy competitive advantages not readily available to other firms operating in the same environment. A collision between an alien institutional logic and the normative and cognitive framework which undergirds a national institutional complex led to the renegotiation of a 'social license to operate'. This change was important in ameliorating both the public furore over the case and the political conflict between interested actors. Further, legislative innovation hit the target, big multinational PEFs. Local private equity firms, who had been acting in greater accord with local expectations, have been less affected by the changes. Several of our interviewees pointed to the TDC case as the singular trigger for the tax changes. The legal changes generated persistent fears of future legislative intervention. The impression left was that the rules of the game may change again, depending on government and public sentiment towards PEFs.

Significantly, other actors have since altered their perception of private equity. Trade unionists accept that while PE raises a series of difficult challenges, in some cases the changes wrought by PEFs are both competitively optimal and inevitable, given conditions of globalization. That constituency commonly considered to be most negatively affected by PE activity accepts this activity as far as the "Danish model" is respected and the competitiveness of laggard Danish firms improved. In 2010, Harald Børsting, the chairman of the Danish Trade Union Confederation (LO), and one of the most powerful actors in the Danish economy, distinguished between good and bad finance firms in the DVCA annual report:

"*There exist both good and bad financial firms. The good financial firms contribute to economic development and increase employment through the development of firms and workplaces; the bad ones achieve their results through lower tax payments... this sector of the economy has developed, and has started to act in a different way*".

This brief excursion into the PE buy-out of TDC and the debate which has simultaneously arose from and partially determined that process highlights how institutional enactment relies upon a contest between agents over legitimation. Debates about legitimacy arise at the intersection of the national and universal to both constrain and enable contingent and path dependent change. Actors are continually re-negotiating the enactment of the regulatory regime, establishing new perceptions of what is considered acceptable and what is not, and sometimes provoking unintended changes by transgressing institutional boundaries.

Discussion and conclusions

We analyse how PEFs gained legitimacy in Denmark and how this process was mediated by national actors and institutions. We suggest that private equity is progressively legitimised via a particular discourse of universal 'freedom'. However, we also showed how contests over legitimacy mobilized actors to shape institutional change. Institutions have been seen as crucial for reducing uncertainty [15]. Coping with institutional expectations through the search for legitimacy has been fundamental to this uncertainty reduction. However, firms are subject to multiple institutional environments and logics with demands, which do not necessarily match. Foreign investors and powerful Danish stakeholders had quite different expectations about how PE should function when taking over a large Danish company. Management may adopt deviant organizational practices in the host economy, which are legitimate in the home country or field in which the PEF is situated, if they are able to play within the intersection of different institutional environments such as the international financial markets and the national institutions. This imposes new exogenous transformative forces on national institutions, and actors may be able to leverage their strengths to reshape the national institutional environment. The case indicates that neo-institutionalism and

business system approaches both seem to underestimate and underspecify the agency of organizational actors in avoiding conformity, and shaping institutions.

In the search for external legitimacy, well-positioned and well-endowed actors may be able to act upon the legitimising process, influencing how legitimacy can be maintained, and the changing patterns of acceptable behaviour. The contest over legitimacy, instead of leading to continuity, generates change in the established institutional patterns. Actors have the agency to respond, resist, shape and negotiate institutional change through institutional enactment. Institutional reproduction is based on the assumption that actors have taken for granted assumptions, world-views and cognitive patterns which are difficult to change, but this is not supported by our observations and analysis. In the same organizational field, actors may present quite divergent expectations about how private equity should function and maintained. This chapter shows that agents of change are not uniquely institutional entrepreneurs or rule makers. Foreign PEF in our cases played fundamental roles in enacting institutions disregarding the question of national legitimacy when they could gain support and acquire resources in other business environments. Therefore, the capability of PEFs to proactively resist and avoid, rather than passively react to, local business systems environments should not be under estimated.

We describe and analyse the process of institutional change as a process partially determined by contestation over legitimacy. We argue that any economic system is composed of a heterogeneity of the actors who in order to improve their positions are likely to reinterpret institutionalized rules when enacting them. We show that economic actors are always participating in struggles to maintain as well as to change or even subvert institutionalized rules and legitimized practices, creating disputes which in turn generate a slow but cumulative and incessant dynamic of change. As a result, even though extant institutional environments materially effect transformative contests, institutional reproduction is only temporarily possible. From time to time, disputes over interests and norms among and within social groups may wreak havoc on institutionalized rules and force embedded groups to restructure internally, reordering their positions and interests. Simply, institutions reproduce, but via a contingent evolutionary process.

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