

## **BVCA Study Proposal Brief**

### **LBO distress: impact on company valuation and wider implications**

The private equity industry has grown rapidly in recent years, and private equity-backed companies have shown themselves to be a significant driver of the UK economy and its global competitiveness. Over the five years to 2006/7 the number of people employed worldwide by UK private equity backed companies increased by an average of 8% p.a., and companies that are private equity backed are responsible for around 6% of UK private sector employment. Over the same period, on average private equity backed companies' sales rose 8% p.a., compared to 5% growth in FTSE 250 companies.

Private equity is more than just the provision of capital; the private equity model is essentially a corporate governance model, aimed at better aligning the interests of owners and managers to increase corporate value. The use of debt boosts the returns to equity but also requires heightened discipline from managers to ensure its adequate servicing, requiring attention to efficiency.

Consequently, the events in the financial sector since August 2007 have had important implications for the private equity model; the main feature of the 'financial crisis' has been the freezing up of credit markets, making it almost impossible to raise debt, not only for buyouts but for any other activity. This has had a significant impact on buyout activity: according to data from CMBOR, the UK PE market dropped to its lowest level for over 13 years in the fourth quarter of 2008. The value of buyouts reached just £994m in Q4 compared to £5.6bn in Q3 and £5.7bn in Q4 2007. Overall, 2008 saw £19.1bn from 549 deals, a fall of over 58% on 2007's record figure of £45.9bn from 671 deals. The size of the market in Q4 is not much larger than the largest European buyout fund raised in 1995.

The inability to raise leverage is not the only, or even the primary concern at the moment. Private equity firms are more concerned about their existing portfolio companies, which have been adversely affected by the slowdown in global economic activity. Of course, this has affected companies across the board, regardless of whether they are privately or publicly owned. However, the use by the private equity business model of high levels of leverage potentially makes the portfolio companies more prone to financial distress at times of economic turbulence: debt has to be serviced (hence the need for discipline) while equity (in the short term, at least) does not. Usually, organizations can rely to a certain degree on their equity cushion to tide them through difficult times, but many deals, particularly those acquired or re-financed in 2006 and 2007 were done at higher EV and debt multiples, which imply that the equity is more sensitive to impairment should valuation metrics fall. As the slowdown impacts the ability of portfolio companies to service their debt, it is likely to lead to increased default, and we are already beginning to see this: Business Week (2008) reports that of the 86 companies around the world that defaulted on their debt in 2008, 53 were involved with private equity deals.

An interesting question - which is currently under-researched in the UK - is the impact of financial distress on the continued operation of companies, and in particular whether the private equity ownership model is important in this regard. Investigating this question would provide some insight into whether the potential increased financial fragility resulting from high levels of leverage is compensated

by the general outperformance of private equity owned firms. One important consideration is that PE-owned companies tend to have pre-leverage betas that are much lower than the market average, reflecting PE firms' tendency to buy companies with steady cash flows, meaning they can afford to incorporate a higher level of debt (beta=0.5 is a rule of thumb, see Gottschalg (2008), Acharya and Kehoe (2008)). It may also be the case that PE firms are better able to renegotiate with creditors – as they are primarily dealing with bank syndicates and there is a concentrated equity representation – compared to PLCs. A further consideration is that the financial investors – debt and equity – both have an interest in maintaining and increasing business value, and therefore may not be inclined to take short term actions to boost profits or cash flow that diminish the longer term value of the business, eg, aggressive cost cutting and/or asset disposals.

We are also interested to know about the wider implications of financial distress, in recognition that there are other 'stakeholders' who are affected by such an event. The impact on such stakeholders is heavily dependent on the bankruptcy regime. There are two considerations. First, the point at which bankruptcy is triggered for a given insolvency regime is significant. Until recently, extensive covenants on loans generally meant that the use of leverage would cause bankruptcy to be triggered earlier, at a point that potentially preserves greater going concern value than in firms that are predominantly equity financed. However, in the current cycle the use of covenant-lite loans gives potential for a company to get into serious trouble before breaching loan conditions. As a result, it is likely that more companies will end up in a formal legal process. Second, the amount recovered also depends on the nature of the bankruptcy regime. While it is widely held that European countries deal with insolvent firms far more severely than America, creditor firms are often treated badly too. The bankruptcy system in the UK differs from Chapter 11 in the US in so far as in the UK, suppliers have the right to terminate contracts in the event of bankruptcy, which quickly disrupts a firms' activities, whereas in the US counterparties have to stay as long as they receive reasonable reassurance that they will be paid (The Economist, 2008).

### **Existing literature in this area**

Jensen (1989) provides an economic rationale for the PE industry, arguing that the combination of concentrated ownership, better management incentives, operating efficiencies and a more leveraged financial structure offer a superior model of operation to the typical public company. In terms of implications of leverage for LBOs, and the debt levels employed, Andrade and Kaplan (1998) examine the value of financially distressed buyouts after the resolution of distress based on the 1980s leveraged buyout wave in the US. They estimate costs of distress not larger than 20% of firm value, and they also estimate that even the financially distressed buyouts were no less, and potentially more valuable, after the resolution of financial distress than they were before the leveraged buyout. Kaplan and Stromberg (2008) examine similarities and differences between the recent private equity wave and the wave of the 1980s. They argue that there is no reason to believe that the outcome of the current wave of defaulting buyouts will be any worse.

There is also a literature that looks at the efficiency of the bankruptcy process. Citron, Wright, Ball and Rippington (2003) use a dataset of 42 failed MBOs in order to gain a deeper understanding of the process by which secured creditors recover funds they have extended to MBOs. They find that secured

creditors recover on average 62% of the amount owed. They find that the percentage recovered is increased where the distressed buyout is sold as a going concern and where the principal reason for failure concerns managerial factors. The presence of a going concern qualification in the audit report and the size of the buyout reduce the recovery rate by secured creditors. In a further paper, Citron and Wright (2008) use a dataset of 57 MBOs in distress and analyse the determinants of bankruptcy costs under the UK's receivership regime. They show that the direct costs of receivership consume a significant percentage of the receivership proceeds.

### **Focus of the study**

It is anticipated that the study would involve an analysis of the relationship between leverage and LBO related bankruptcies in the UK, to examine the implications for company valuation of financial distress. The study would initially have two stages:

- First, monitoring and analysis of the existing situation, by obtaining data to give an idea of the magnitude of the problem at the present time, in both private-equity owned and public companies (CMBOR have a useful database). This would cover default and bankruptcy rates, as well as actions taken in distress, eg, job reductions. Also, trying to form a view on the major underlying reasons behind the distress.
- Second, examination of some case studies of private equity owned portfolio companies that have suffered distress, and comparison to bankruptcies of publicly owned companies. This would include examining aspects of how the management / governance /action plans were implemented and outcomes, in order to give some suggestions as to best practice. Ideally there would also be some segmentation, looking at the difference between the midmarket and large buyout ends of the market.

### **Audience for the study**

This study should be of interest to policymakers and academics; it should also be helpful for the BVCA's lobbying on behalf of its members, as the results are likely to provide confirmation that private equity firms take a sensible approach in determining the amounts of leverage a portfolio company can support, and that financial distress, when it occurs, does not tend to have a particularly negative effect on the underlying operations of the company.

## References

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