

Private Equity and Buy-outs: Jobs, Leverage, Longevity and Sell-offs

The recent pressure for tighter regulation of the private equity industry has arisen from allegations and press comment that private equity firms strip the assets of their portfolio firms to the detriment of employees and their longer term performance, and 'flip' them as IPOs or trade sales in short periods of time. Extensive media coverage following concerted efforts by the trade unions has in turn resulted in demands for restrictions on employment shedding following a buy-out and increased transparency within the private equity (PE) industry. Recently the debate has been expanded further, calling for an end to the perceived favorable tax treatment of the private equity industry, both in terms of the lower corporation tax payable due to the negative effect on profitability of interest repayments in highly leveraged structures and the taxation treatment of PE executives' income from carried interest.

In this article, we comment on the issues of employment and wages, leverage, the extent of restructuring and disposals and the longevity of private equity investments.

Employment and wages

Private equity firms do not choose companies for buy-outs at random. A buy-out would be unlikely to occur if the pre-buy-out firm was performing well because there would be few performance gains to be obtained from restructuring. When a firm is under-performing this is likely to be reflected in labour productivity figures. Our systematic evidence from almost 5,000 buy-out plants, the largest ever study of buy-outs, shows that the efficiency of the business post-MBO is often improved by saving on labour costs by cutting jobs around the time of the change in ownership. Indeed, on average MBO/I plants had lower total factor productivity (i.e. the productivity of assets and labour) before the buy-out than their non-buy-out counterparts, suggesting a degree of over-manning. It is perhaps not surprising then that some labour shedding occurs.

Our analysis of a panel of 1,350 U.K. LBOs observed over the period 1999-2004 in a separate study, provides evidence that when buy-outs are disaggregated, employment growth is 0.51 of a percentage point higher for MBOs after the change in ownership and 0.81 of a percentage point lower for MBIs than in companies which have not undergone a buy-out.

More detailed data of the trend in employment over time (Table 1) shows that:

- In MBOs employment dips initially after the buyout but then continues to rise, on average.
- In contrast, for MBIs, the employment level remains below the pre-buy-out level.
- For both MBOs and MBIs, the majority of deals show an increase in employment.
- The effects of buy-outs on estimated employment growth rates are similar to those for traditional acquisitions.

Table 1: The Post-MBO and Post-MBI Changes in Employment and Remuneration Per Employee

| Variables | Years relative to year of deal | | | | | |
|----------------------------------|--------------------------------|-----------|-----------|-----------|-----------|-----------|
| | t + 1 | t + 2 | t + 3 | t + 4 | t + 5 | t + 6 |
| MBO: | | | | | | |
| <i>Employment</i> | -2.28% | 2.96% | 7.46% | 21.43% | 26.02% | 36.19% |
| | (-0.63) | (0.63) | (1.28) | (3.31)*** | (3.15)*** | (2.44) ** |
| % deals with positive change | 60.19% | 65.12% | 66.08% | 64.32% | 61.70% | 61.42% |
| % deals with negative change | 35.73% | 33.22% | 32.16% | 34.02% | 36.17% | 36.22% |
| % deals with no change | 4.08% | 1.66% | 1.77% | 1.66% | 2.13% | 2.36% |
| <i>Remuneration per employee</i> | 6.30% | 11.22% | 15.05% | 19.89% | 26.91% | 28.27% |
| | (3.80)*** | (6.07)*** | (6.62)*** | (6.86)*** | (5.05)*** | (6.47)*** |
| % deals with positive change | 71.47% | 75.67% | 77.30% | 81.67% | 83.96% | 86.61% |
| % deals with negative change | 28.53% | 24.33% | 22.70% | 18.33% | 16.04% | 13.39% |
| % deals with no change | 0 | 0 | 0 | 0 | 0 | 0 |
| <i>Number of deals</i> | 319 | 301 | 283 | 241 | 188 | 127 |
| MBI: | | | | | | |
| <i>Employment</i> | -10.22% | -9.70% | -11.10% | -3.35% | -5.02% | -18.26% |
| | (-1.46) | (-1.24) | (1.24) | (-0.31) | (-0.37) | (-0.55) |
| % deals with positive change | 57.5% | 59.82% | 58.65% | 56.32% | 55.93% | 64.86% |
| % deals with negative change | 36.66% | 36.61% | 38.46% | 39.08% | 42.37% | 35.10% |
| % deals with no change | 5.83% | 3.57% | 2.88% | 4.60% | 1.69% | 0 |
| <i>Remuneration per employee</i> | 5.49 | 10.04% | 15.47% | 17.59% | 25.03% | 38.84% |
| | (1.57) | (2.56)** | (3.46)*** | (3.03)*** | (3.33)*** | (4.74)*** |
| % deals with positive change | 63.87% | 72.07% | 81.55% | 79.07% | 86.21% | 94.49% |
| % deals with negative change | 35.13% | 27.93% | 18.45% | 20.93% | 13.79% | 5.41% |
| % deals with no change | 0 | 0 | 0 | 0 | 0 | 0 |
| <i>Number of deals</i> | 120 | 112 | 104 | 87 | 59 | 37 |

Notes: (1) column $t + s$ ($s = 1, 2, \dots, 6$) shows the per cent change in the relevant variable s years after the deal compared to the year prior to the deal ($t - 1$) on a deal-by-deal pairing. Thus, the employment change of 21.43% four years after the deal indicates that employment grew by $21.43/5 = 4.29\%$ per annum; (2) paired t-statistics of equality between $t - 1$ and $t + s$ years after the deal are in parentheses; (3) ***, **, and * indicates significance at the 1, 5, and 10% level, respectively.

Source: The employment and remuneration data are obtained from FAME and matched with the CMBOR database that provides information on the date of deals and exits. Due to exits the number of deals in the analysis declines over time. This means that caution must be taken when comparing changes in different buyouts periods. The advantage of this approach, however, is that we use all available deals and do not introduce bias by discarding deals in order to keep the sample size the same in each post-buyout period.

The same study also indicates that average growth in wage levels in MBOs and MBIs is marginally lower than in firms which have not undergone a buy-out. These findings need to be considered with care, since pre-buy-out remuneration may not have been sustainable if firms had been under-performing. Our analysis does not encompass the trend pre-buy-out so it is not possible to tell whether buy-outs had a higher or lower wages trend than non-buy-outs and hence whether the position is

worse, better or the same after buy-out. It is also problematical to integrate the weekly/monthly wage aspects of remuneration and any benefits from the introduction of employee share ownership schemes at the point of the buy-out; the latter may substitute for standard wage payments which may not necessarily be the same in non-buy-outs. Thus, our findings are likely to bias against finding positive wage effects due to buy-outs if they are more likely to use such schemes than non-buy-outs. These schemes can be important because they allow employees to share in the performance gains associated with the typical LBO. Further research is needed to examine this aspect.

The buy-out market comprises both private equity backed and non-private equity backed deals. It is possible to conjecture that the impact of PE backed deals is different from that from non-private equity backed deals but as yet there is no published systematic evidence. The specific employment impact of PE backed deals is currently work in progress.

The reasons why MBOs and MBIs are, on average, different with respect to employment and wages need to be examined. Evidence shows that post-MBI restructuring is greater than for MBOs and that MBI performance is below that for MBOs. Research from CMBOR also shows a higher failure rate of MBIs compared to MBOs. All this evidence points to MBIs being more problematical.

The origins of buy-outs in the UK in the 1980s were very much focused on saving jobs through restructuring troubled businesses. Where there is little alternative except closure, a private equity deal even with a reduced workforce may have its attractions. Our analysis shows that actions to restructure the business on buy-out, including labour shedding, appear to reduce the likelihood that the firm will subsequently fail with the likelihood of even higher loss of employment. It is, therefore, simplistic to take a wholly negative view of MBIs since the status quo ante may not have been sustainable. Further analysis is needed to link these factors to wages and employment.

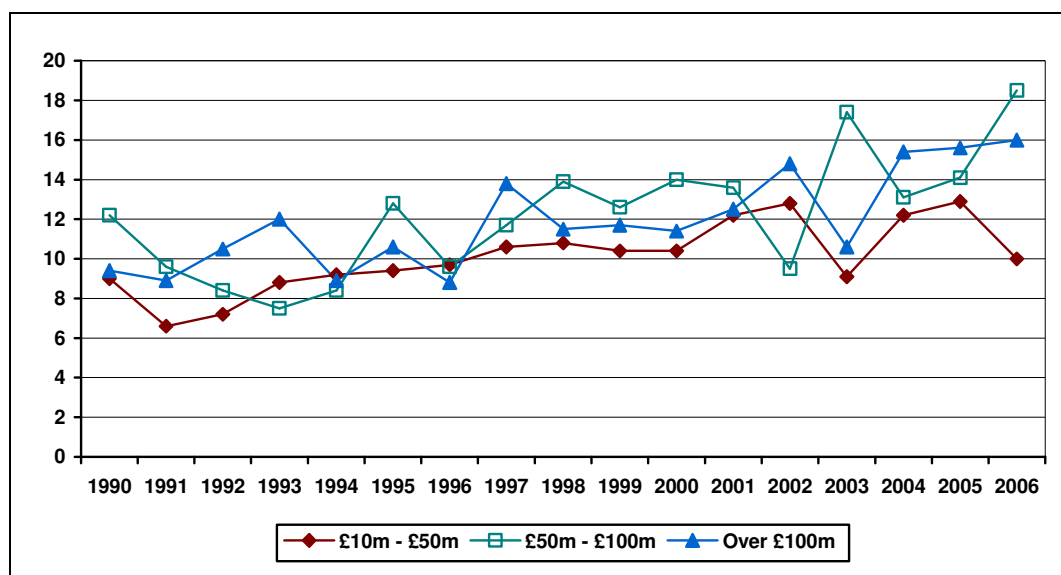
In addition to the tax treatment of PE executives' own investment (carried interest) into a buy-out firm, the current debate has also raised important issues concerning the distribution of gains between private equity executives, senior executives of the investee firms and the wider body of employees of the investee firms. One approach to addressing the policy concerns regarding the distribution of the gains from private equity transactions may be to extend the use of employee share ownership schemes (ESOPs) which allow for direct participation by the wider body of employees in the upside benefits. However, such schemes may not be appropriate to motivate and remunerate employees in all cases. Rather, ESOP mechanisms may be more appropriate in cases where employees have specific skills that would be difficult to replace, where there are problems in direct monitoring or where there are strong unions. These schemes have tended to be more widely used in privatization cases but may have an important role to play in firms where employees are widely distributed geographically. These mechanisms may also not motivate employees as owners where they are not accompanied by the involvement of employees in the direction of the firm. If policies are introduced to stimulate ESOPs, therefore, there is a need to be clear about their purpose.

Leverage

Another subject of current debate has been the perceived favourable tax treatment of private equity firms, which typically use high levels of debt to fund buy-outs. Interest payments are offset against earnings, consequently lowering profitability and hence corporation tax levels, although clearly this tax relief benefit is also available to any other highly leveraged firms.

One area of concern, however, is that high levels of debt in the PE system currently could pose potential dangers, although as yet there have been very few large scale defaults. Overall debt levels have increased in recent years with the overall average combined share of financing accounted for by senior and mezzanine debt increasing from 46.3% in 2000 to 55.0% in 2006. Among the very largest deals in the UK (>£500m) total debt financing has increased from 56.0% in 2000 to 69.6% in 2006. In addition to increased leverage, concerns have also emerged about the sustainability of private equity returns due to the general increase over time in entry EBIT multiples (Figure 1). For example the number of buy-outs with an enterprise transaction value of over £100 million has grown from just 10 in 1996 to a record 58 in 2006 and there has been a marked increase in EBIT multiples from around 9 in 1996 to almost 16 in 2006.

Fig. 1: Entry EBIT Multiples for UK Buy-outs



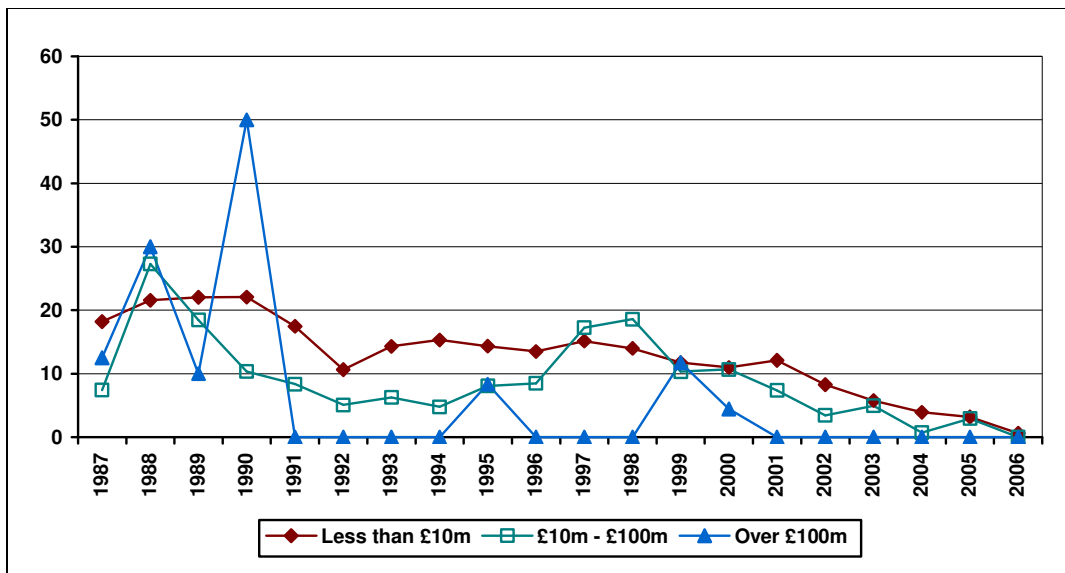
Source: CMBOR/Barclays Private Equity/Deloitte

Over the same period, the ratio of debt to earnings has also risen, increasing from 5.6 to 9.0 for these larger deals over the same period. Interest rate rises could still play a big part in the LBO market's fortunes as they did in the early 1990s. High levels of consumer debt especially in the US and UK could be vulnerable to any unforeseen economic shock. A subsequent slowdown in GDP could threaten the buy-out market and make it more difficult to service large amounts of debt.

Our evidence from the peak period of buy-outs in the 1980s shows that high

leverage and low firm liquidity are associated with subsequent buy-out failure. It is important to distinguish between income and capital leverage. While much attention has focused on capital gearing, (the amount of debt in the buy-out structure) income gearing (the ability of the buy-out firm to service its debt) is arguably more important since cash flow coverage of interest payments is a stronger indicator of ability to service debt. Private equity deals can sustain high capital leverage if they have high and stable interest coverage. A problem with deals completed in the late 1980s with high leverage was that insufficient attention was paid to the stability of cash flows in recessionary conditions. To date, few of the largest deals in the UK have failed and in general larger deals have lower failure rates. However, it is evident that in recessionary conditions, there is a notable increase in failure rates (Figure 2). There is a need for close monitoring of developments.

Fig. 2: Percentage of UK Buy-outs/Buy-ins ending in Receivership by Value Range/Vintage Year



Source: CMBOR/Barclays Private Equity/Deloitte

Longevity of private equity investments

Our evidence shows that few private equity deals can be described as involving the flipping of transactions within a short period of time following the buy-out (Table 2). That there have been some recent very short periods to exit of private equity deals is not new and should not be surprising. Some deals can fail quickly while others may receive unsolicited bids by trade buyers within a short time after buy-out. Although there are some variations in the average time taken to exit for deals that exited in a particular year, the average is in the range just below 4 years to just over 5 years.

Table 2: Average Time to Exit for UK Buy-outs/Buy-ins by Exit Year

| Year of Exit | Number of Exits | Average Time to Exit (months) |
|---------------------|------------------------|--------------------------------------|
| 1981 | 6 | 70.0 |
| 1982 | 6 | 37.2 |
| 1983 | 10 | 37.1 |
| 1984 | 21 | 31.0 |
| 1985 | 43 | 50.9 |
| 1986 | 76 | 42.9 |
| 1987 | 86 | 45.0 |
| 1988 | 118 | 44.5 |
| 1989 | 159 | 41.2 |
| 1990 | 174 | 42.1 |
| 1991 | 178 | 41.9 |
| 1992 | 195 | 49.6 |
| 1993 | 219 | 49.3 |
| 1994 | 216 | 55.7 |
| 1995 | 243 | 57.8 |
| 1996 | 279 | 61.3 |
| 1997 | 265 | 64.1 |
| 1998 | 284 | 54.2 |
| 1999 | 251 | 60.7 |
| 2000 | 289 | 54.3 |
| 2001 | 257 | 66.7 |
| 2002 | 279 | 61.9 |
| 2003 | 249 | 70.8 |
| 2004 | 331 | 62.5 |
| 2005 | 345 | 60.3 |
| 2006 | 331 | 62.9 |

Source: CMBOR/Barclays Private Equity/Deloitte

Secondary buy-outs are becoming increasingly popular as exit routes for private equity across Europe. The growing number of large secondary buy-outs, provides useful liquidity for the buy-out market at a time when alternative exit routes have become difficult. These deals may lead to the prolongation of disintermediation from public markets but may maintain the positive benefits of private equity governance and incentives as a longer term organizational form. However, these transactions raise important and challenging unresolved issues relating to performance evaluation. In particular, if the original private equity financiers were effective, how likely is it that further performance gains can be achieved?

For the incoming investors in secondary buy-outs, an important issue is: will managers be buyers or sellers in the deal and what will be the impact on performance? Furthermore, when management increases its equity stake, there may be a corresponding reduction in control by the private equity firm. This may result in management embarking on risky growth strategies with little monitoring. There are anecdotal examples of the effects of secondary buy-outs and initial evidence is that returns to exiting through secondary buy-out are lower than for IPOs and sales to corporate buyers. An unresolved issue about secondary buy-outs concerns the possibility that limited partners will be asked by private equity firms to invest again in the same deal through a subsequent fund, and presumably at a higher price than the first time around. While exit from the first buy-out allows the realization of capital gains, limited partners may take some convincing that further significant capital gains will be forthcoming.

Refinancing and partial sales

Refinancing may involve either the private equity firm having the business borrow more and then paying themselves special dividends from the borrowings or engaging in a sale and leaseback of property assets to a third party and transferring the proceeds from the sale to the PE firm in the form of a dividend. With respect to refinancing, in the UK in 2006 total refinancings accounted for just under a fifth of the total value realized, compared to a little over a tenth in 1997 (Table 3).. Between 55 and 90 recapitalisations have been recorded each year in the UK (Table 4). The total value of recapitalisations in 2006 was £7.5 billion compared to a total buy-out value of over £26 billion.

Table 3: Total Value Realised for UK Buy-outs/Buy-ins

| Year | Total Exit Value (£m) | Total Refinance Value (£m) | Total Partial Exit Value (£m) | Total Value Realised (£m) |
|------|-----------------------|----------------------------|-------------------------------|---------------------------|
| 1998 | 4433 | 1742 | 108 | 6283 |
| 1999 | 6502 | 1042 | 927 | 8471 |
| 2000 | 9857 | 4234 | 2648 | 16739 |
| 2001 | 8451 | 4194 | 5534 | 18179 |
| 2002 | 10844 | 3663 | 3080 | 17587 |
| 2003 | 8854 | 2508 | 2057 | 13419 |
| 2004 | 18231 | 10456 | 5811 | 34498 |
| 2005 | 21998 | 12603 | 6239 | 40840 |
| 2006 | 26855 | 7457 | 4279 | 38591 |

Source: CMBOR/Barclays Private Equity/Deloitte

Table 4: Total Number of UK Buy-out Exits, Partial Sales & Refinancings

| Year | Number of Exits | Number of Refinance | Number of Partial Sales | Total Number |
|------|-----------------|---------------------|-------------------------|--------------|
| 1998 | 284 | 94 | 12 | 390 |
| 1999 | 251 | 86 | 50 | 387 |
| 2000 | 289 | 99 | 77 | 465 |
| 2001 | 257 | 79 | 92 | 428 |
| 2002 | 279 | 82 | 70 | 431 |
| 2003 | 249 | 55 | 77 | 381 |
| 2004 | 331 | 85 | 70 | 486 |
| 2005 | 345 | 62 | 98 | 505 |
| 2006 | 331 | 54 | 66 | 451 |

Source: CMBOR/Barclays Private Equity/Deloitte

A partial sale of the portfolio company provides another means of realising part of the initial investment. Partial sales made up just over a third of the total value realized in the U.K. in 2001, but have since become less frequent and accounted for just over tenth of the total in 2006. The number of partial sales recorded is generally between 70 and 100 per annum, with a further £4.3 billion value realised through partial sales in the UK in 2006.

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