ETUI Policy Brief
European Economic and Employment Policy
Issue 3/2009

The growing crisis in private equity: binding regulation and an action plan are needed

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Policy implications

There is a storm brewing in private equity as the economic crisis raises the threat of bankruptcy or default over perhaps as many as one in two firms acquired by PE funds. This poses a major additional threat to the already weakened banking sector. Two sets of policy issues emerge. First, regulation is needed to improve transparency, discourage destructive financing and industrial relations practices, and support worker rights to information, consultation and negotiation. An independent European rating agency is also needed to monitor PE investments. Second, in order to protect employment at PE-financed companies from the threat of increasing default on LBO debt, an action plan is urgently needed to secure refinancing for PE portfolio companies. This action plan will need the support of governments, institutional investors, the PE industry and trade unions.

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Introduction

Although much of the initial analysis of the financial crisis has focused on the subprime mortgage market, problems in other types of credit market are becoming increasingly apparent. Currently a major crisis is developing in the leveraged buyout (LBO) industry, where private equity (PE) firms have used approximately EUR 500 billion in loans to supplement their own equity investments of EUR 280 in European companies. Due to the deterioration in the economic climate, many of these companies will be unable to meet scheduled interest payments. Estimates are that companies may default on up to half of this LBO debt in the next few years. Furthermore, even many companies that do meet interest payments may be in trouble, since PE firms cannot resell them and refinancing is difficult, meaning that the principal on term loans has to be repaid.

Even under favorable macroeconomic conditions, PE investment has been shown to lead to job and wage losses in portfolio companies, and this pressure is increasing under the strain of the financial crisis.[1] However, this growing crisis threatens not only employment, working conditions and the quality of industrial relations in many companies, but also the goal of regaining financial stability. Large banks hold a significant portion of this LBO debt on their own books (estimates run between EUR 50-80 billion), and this amount is highly concentrated among a few major participants in leveraged loan origination. Further losses on these loans will result in more erosion of the capital of large banks and thus reduced ability to issue new loans. Institutional investors (e.g. pension funds) also hold substantial LBO debt, and will have to sell off liquid assets, such as publicly traded equities, to meet cash obligations, putting further pressure on financial profits.

The current situation in private equity

The classic PE investment strategy has a number of elements. First, a PE firm will acquire a controlling stake in a company (generally referred to as a "target" or "portfolio" firm in the PE industry). These companies might be family-owned, divisions of larger firms, or listed on the stock market and taken private. Second, the PE firm attempts to use this control to implement operational and/or governance changes which will increase the value of the company. Third, the PE investor attempts to realize its profit by reselling the target company ("exiting") to another

1 For a survey see Andrew Watt (2008) 'The impact of private equity on European companies and workers: key issues and a review of the evidence', *Industrial Relations Journal*, 39:6, 548–568.

company, to another PE investor, or to the public on the stock market. A key element is the use of leverage, i.e. the use of debt to finance the bulk of the acquisition of the target firm, which allows the PE investor to increase its profit if the target company's value is significantly enhanced. Supporters of PE have also claimed that high leverage is a positive governance factor, since it acts as a disciplining device forcing management to improve operations.

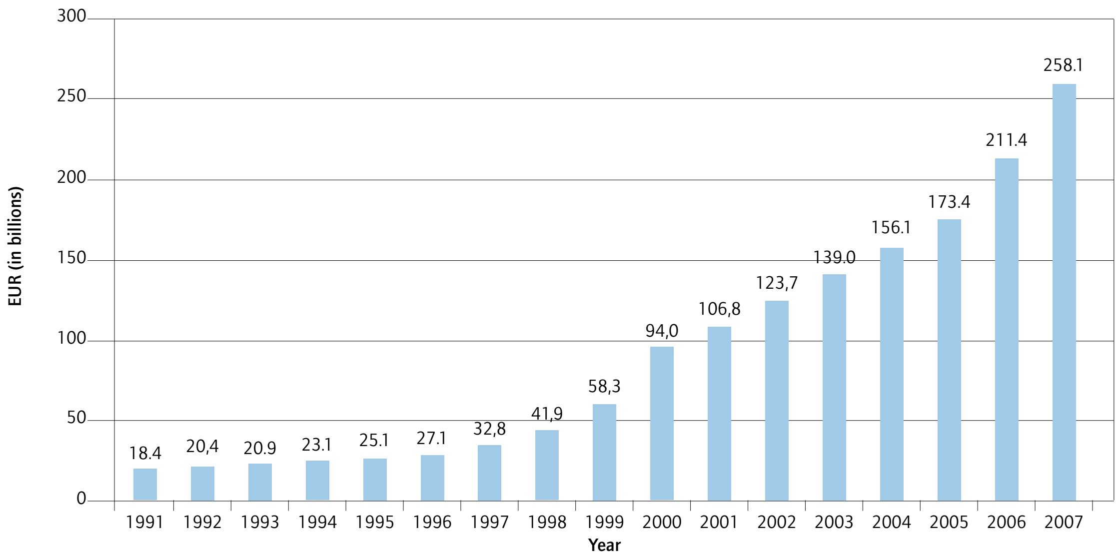
With the exception of a dip after the peak of the high tech bubble in 2000, European private equity activity has been increasing at a very rapid pace over the past two decades. This activity reached a peak of about EUR 74 billion of private equity invested in 2007.[2] Given a typical holding period of PE investments of 3-5 years, the portfolio of European companies in which PE has an equity stake has also grown at a rapid pace. By the end of 2007 the total value of the European private equity portfolio was estimated at just short of EUR 260 billion (see Graph 1).

Reflecting the increasing appetite for risk among investors through much of this decade, the characteristics of PE investments became much more speculative up through 2007/8. One indicator of this is the purchase price of target companies, measured as a multiple of EBITDA, a commonly used indicator of profitability.[3] According to the rating agency Standard and Poor's, this multiple increased from about seven (including deal fees and expenses) at the beginning of this decade to roughly ten in 2007/8.

A second indicator of investors' increasing appetite for risk is the average proportion of deal finance provided by equity (either by the PE investor or through equity retained by the original investor) versus through debt. The proportion of debt in the total capital used for financing the deal (commonly called leverage) measures the potential reward but also the risk of the PE deal. If the profit rate on capital is higher than the interest rate on the debt, then the extra return will flow to the equity investors, who will enjoy a proportionately higher profit rate. However, since interest payments must be serviced before payments to equity, the danger is that if the profit rate on capital falls below the interest rate, then equity investors will suffer a proportionately lower rate of return or even a loss. According to Standard & Poor's, during this decade the proportion of equity financing (provided by both PE and original investors) dropped from around 38-39 percent to just about 33 percent, implying a significant rise in already substantial leverage.

Since the proportion of LBO deal financing provided by equity is roughly one third, then the value of LBO debt outstanding should be roughly twice the value of the equity portfolio. Since this was quite probably in the neighbourhood of EUR 280 billion by the end of 2008, then a very rough estimate of the face value of European LBO debt currently outstanding is EUR 500 billion. Given the structure of LBO debt financing, some of this debt would still be held by banks, some by institutional investors as outright loans, and some by institutional investors in the form of CDOs (collateralized debt obligations).

Graph 1 **Value of the European private equity portfolio (EUR billions)**



Source: EVCA Yearbook 2007.

2 Although figures for 2008 were not available from the European Venture Capital Association (EVCA) at the time of writing of this report, information from other sources indicates that investment activity decreased dramatically in 2008.

3 EBITDA is a measure of profits or earnings before payments for interest and taxes and accounting for depreciation and amortization are subtracted. This is a measure of profitability commonly used in the PE industry, since it measures profitability independent of capital structure – and thus in principle the profitability of companies after exit and deleverage.

A final indicator of investors' risk orientation is the number and stringency of covenants included in loan agreements, in other words, conditions requiring the borrower to undertake certain actions or to avoid specific conditions. Creditors try to include covenants in loan agreements to discourage borrowers from taking actions which would increase the probability of default as well as to provide an early warning system for potential default. During the height of PE activity in 2005, 2006 and early 2007, the number and stringency of covenants included in LBO loans decreased significantly.[4]

Since late August/early September 2008, however, the value of much of this outstanding debt has been severely devalued given a sea change in the market perception of risk. Investors' estimates of the probability of default have increased greatly over the past year. Furthermore, the decrease in the value of the stock market by roughly half has made it more difficult for PE to exit target companies at a large profit. Larger packages of leveraged loans trade actively in a secondary market, and the current market price of this debt is a good indicator of the market perception of the probability of default of the issuers of this debt. Whereas this leveraged debt was trading at roughly 90-95 percent of face value at the beginning of 2008, the mark-to-market value of this debt had plunged to less than 65 percent by the end of 2008 (see Graph 2).

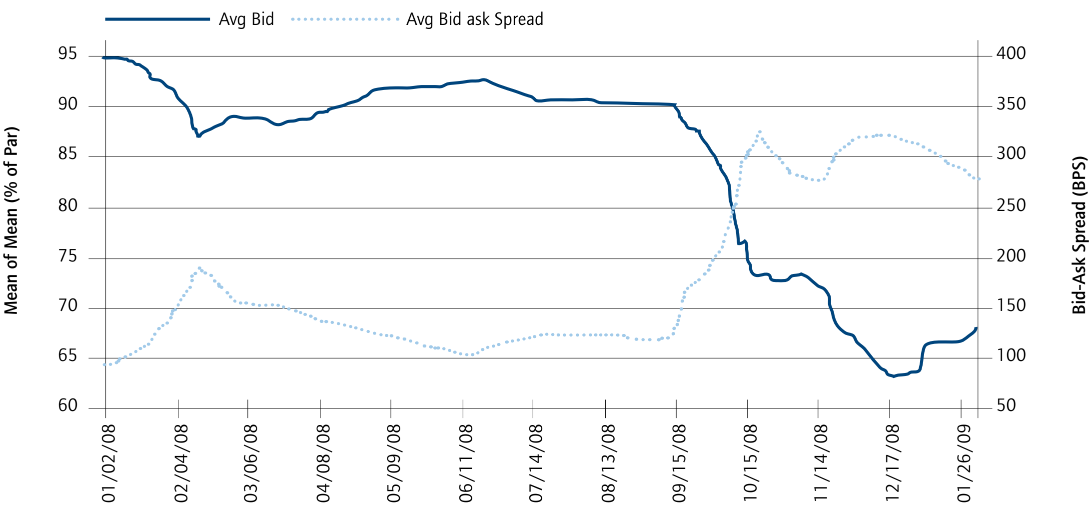
Based on similar data, a study by the Boston Consulting Group and IESE business school found out that the loans of roughly 60 percent of LBO debt were trading at distressed levels, i.e. at levels reflecting market judgment of a very high probability of default (operationalised as a 10-percentage-point spread above short-term interest rates). The study derived a three-year cumulative default probability on the outstanding LBO debt of 49 percent, i.e. the estimate is that roughly half of the target companies would go into default over the next three years.[5]

Given the estimate of roughly EUR 500 billion of European LBO debt outstanding derived earlier, this would translate into defaults on approximately EUR 250 billion of this debt. In addition, approximately EUR 140 billion in equity investments by PE would have to be written off.

Private equity and financial stability

Although some commentators have downplayed the dangers of PE for financial stability, the figures presented in the previous section show that PE activity has in fact generated a major risk for the financial system.[6] Given the complexity of the PE financing process, this risk is distributed along different parts of the system, including originating banks, institutional

Graph 2 **Mark to market pricing of leveraged loans**



Source: LSTA (Loan Syndication and Trading Association) www.lsta.org

4 So-called "covenant-lite" loan agreements reduce the power of lenders, since they do not include the maintenance covenant which is typically included in loan agreements. Maintenance covenants are automatically triggered once debt levels exceed a certain multiple of earnings. Standard & Poor's estimates that covenant-lite loans accounted for 35% of the institutional leveraged loan volume in the first quarter of 2007 (Standard & Poor's RatingsDirect "The Covenant-Lite Juggernaut Is Raising CLO Risks – And Standard & Poor's Is Responding", June 12 2007, p. 6).

5 Boston Consulting Group-IESE Business School "Get ready for the private equity shakeout: will this be the next shock to the global economy?", December 2008, download under www.bcg.com.

6 This comes on top of the more direct increase in the fragility of the real economy through PE activity, not discussed in detail here: by loading companies up with debt so as to maximize their own returns, PE increases the risk of bankruptcy at the level of individual companies. In sum, this makes the corporate sector as a whole more fragile in the face of falling demand and output.

investors that have purchased LBO debt from originators, and also institutional investors who have invested directly in PE. The LBO debt problem contributes to the current financial crisis not only directly, through the partial writedown of LBO debt by originating banks. The financial system is also indirectly affected, as institutional investors are not realizing expected cash flow from LBO-related investments and resort to forced selling of other assets in order to meet funding obligations. These risk points are analyzed in turn.

Large banks

Large banks in Europe and the US have in large part shifted from a strategy of holding loans on their books until maturity to an "originate-to-distribute" financing model. In principle this allows banks to focus on generating income from the fees involved in loan origination. In syndicated loans, a particularly large proportion of fees goes to the lead syndicator. As a result, originating banks are in principle not faced with the long-term default risks of this debt, and also do not have to tie up capital that would have to be set aside to act as a buffer for loan losses. It is widely understood that the Basle II capital adequacy agreement for banks has contributed to this process by setting low capital requirements for this type of activity.

Some large European banks have been very active in this activity, both within and outside of Europe. Figures from Reuters indicate that eight of the top ten banks in terms of volume of syndicated loan volume in the EMEA (Europe, Middle East and Africa) region in 2007 were based in Europe (see Table 1). On a global level, seven of the ten top banks were based in Europe.

Although in principle risk is shifted to other investors by selling off the loans, in fact originating banks are subject to "warehouse risk" caused by lags between the time when they make a loan commitment and the time when the loans are actually sold. This time lag is greater for loans that are intended to be securitized, since the bank may have to wait until loans from other LBO deals are available for packaging.[7]

A survey carried out by the European Central Bank shows that this risk is concentrated on the balance sheets of a few large banks.[8] The net exposure to LBO debt for the top quartile of EU banks by exposure amounted to roughly 25 percent of Tier 1 capital. Furthermore, large banks are highly exposed to a small number of deals. The median exposure to the top five LBO deals in the portfolios of large banks following the "originate to sell" model amounted to 60 percent of the total LBO portfolio.

Since 2007 the degree of warehouse risk has increased dramatically, since institutional investors have been less willing to buy leveraged loans and banks have built up a considerable backlog of this debt on their balance sheets. As the value of outstanding leveraged loans plunged dramatically in the fourth quarter of 2008, banks have written down part of these losses. Due to lack of transparency in reporting, however, it is difficult to ascertain how much of this debt is still on banks' balance sheets. The BCG-IESE report estimates that this amount is probably somewhere between EUR 50-80 billion, i.e. still a substantial risk to bank balance sheets and thus to financial system stability.

Table 1 **Europe, Middle East & Africa, mandated arranger league table, 2007**

Rank	Bank holding company	Arranged loans (billion $)	# deals	Mkt share
1	Royal Bank of Scotland	123.4	295	7.70%
2	BNP Paribas	112.1	414	7.00%
3	Citi	87.1	232	5.40%
4	Barclays Bank	80.5	209	5.00%
5	Calyon	76.0	243	4.70%
6	Société Générale	68.7	220	4.30%
7	Deutsche Bank	61.1	138	3.80%
8	JP Morgan	59.8	117	3.70%
9	HSBC	53.5	166	3.30%
10	ABN AMRO	52.4	169	3.30%

Source: Reuters LPC (Loan Pricing Corporation) www.loanpricing.com

Institutional investors

Institutional investors are affected by the developing PE crisis in two ways: as purchasers of LBO debt, and as investors in PE funds. The LBO debt problem contributed to the current financial crisis directly, through the partial write-down of LBO debt, which reduced the value of institutional investors' assets. However, institutional investors that invested directly in PE funds were affected in a second way due to the nature of the PE investment model. PE funds are generally established for a fixed period of time (typically for 10-12 years), and during the fundraising process institutional investors make financial commitments up to a certain maximum amount. As limited partners (LPs) in the PE fund, institutional investors have little control over the timing and realization of PE investments. The firm managing the day-to-day activities of the PE fund (the general partner, or GP) can use this commitment flexibly by requiring institutional investors to provide cash on an as-needed basis. Furthermore, many investments are realized before the end of the PE fund's lifetime. This introduces considerable uncertainty for the institutional investor regarding the timing of cash draw-downs and distributions. Since the financial crisis rendered projections of PE investment cashflows much too optimistic, institutional investors were forced to sell other assets in order to meet funding obligations. As losses will continue to mount, institutional investors may be forced to continue their selling of these other assets, keeping downward pressure on securities market prices.

7 Bank for International Settlements, Committee on the Global Financial System, CGFS Paper No. 30, "Private equity and leveraged finance markets" (July 2008).
8 Source: ECB "Large Banks and Private Equity-Sponsored Leveraged Buyouts in the EU" (April 2007)

Policy implications: the need for binding regulation and an action plan

The analysis in the previous sections indicates the need for binding regulation as well as a plan of action in order to deal with the developing crisis in the PE industry. At a minimum, the following measures are needed:

- Information, consultation and participation rights in Europe need to be upgraded to ensure that workers are informed about the economic status of their company and have real bargaining rights before PE deals are consummated, during the restructuring process, and before exit. In particular, workers need to have a veto right over the extraction of value from the company by PE firms in the form of dividends, special dividends, recapitalizations, special fees, and so forth

- The legislative and regulatory environment needs to be reformed to restrict the use of high-risk LBO finance (including covenant-light and high leverage financing models), to ensure that stakeholders retain a voice in restructuring and recapitalization operations (e.g. special dividends), and to discourage tax-driven LBOs.

- Transparency in the PE industry needs to be increased dramatically, through the passage of binding reporting requirements on PE firms regarding their strategies, level of risk, and detailed information on the financial and employment status in each of their portfolio companies.

- A European rating agency should be established to provide objective ratings not only on the financial soundness and default probabilities of issuer companies but also on a wide variety of social and environmental practices (based e.g. on the GRI G3 guidelines). Funding for this European rating agency should be independent of the will of companies rated. Ratings should be mandatory for all issues above a certain size (e.g. EUR 100 million). European institutional investors should be allowed to make substantial investments (e.g. EUR 100 million and up) only in foreign companies that have also been rated by this agency. These ratings should be publicly available at no cost.

- A binding regulatory framework creating a level playing field for all collective investment vehicles (i.e. including PE and hedge funds) needs to be created and enforced.

- A detailed and immediate assessment of the ownership of LBO debt (as well as other high-risk debt) and the extent of its risk to financial stability needs to be carried out.

- A plan of action should be developed for dealing with the growing PE crisis, which potentially threatens thousands of companies and millions of workers. An inventory of PE portfolio companies and their employment and financial status (including level of debt and probability of default) should be drawn up. An early warning system should be developed to identify a deterioration in financial status of companies as well as upcoming refinancing needs (due e.g. to the expiration of a term loan). Refinancing should include an increase in PE equity allocations to portfolio firms if replacement finance cannot be secured for expiring term loans. This action plan needs to be supported by a common understanding involving significant investors in PE and LBO debt, the PE industry, government and trade unions.

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 ISSN 2031-8782
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