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Private equity portfolio company performance during the global recession

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ABSTRACT

We assess the recent economic and financial performance of U.K. private equity (PE) backed buyouts. Our empirical evidence, which is based on thousands of transactions, reveals that PE-backed buyouts achieved superior economic and financial performance in the period before and during the recent global recession, relative to comparable firms that did not experience such transactions. Our regression results imply positive differentials of 5–15% in productivity and approximately 3–5% in profitability for buyout firms, relative to non-buyout firms. Another key finding is that revenue and employment growth for PE- backed firms were positive during the sample period.

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1. Introduction

The second wave of private equity (henceforth, PE) transactions reached an all-time peak in 2007 (Fig. 1). The worst recession since the 1930s, which began in 2008, meant that prospects for many businesses became severely challenged, including those that had been subject to a buyout. The rapid growth of the PE and buyout market has attracted considerable attention from policymakers, the media and unions. Critics of these transactions asserted that the high leverage typically associated with these deals would lead to short term performance horizons, reductions in employment, and increased insolvency risk particularly in an economic downturn (e.g. ITUC, 2007; TUC, 2007; Rasmussen, 2008).

Defenders of PE counter that favorable credit conditions, notably low interest rates, were a major driver of the amount of leverage in PE deals (Axelson et al., 2010) and that, in the early stages of the buyout, optimal leverage may be high (Kortweg, 2010). A focus by PE firms on investing in stable sectors with strong cash flow, and in companies with identified potential for performance and productivity improvement (Kaplan and Stromberg, 2009), implies that portfolio companies are better able to withstand economic downturns. Close monitoring and timely intervention by PE investors to deal with financial problems may also mean that the performance of portfolio companies is maintained.

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Recent studies of the second wave of PE transactions indicate that buyouts result in significant improvements in financial performance and total factor productivity, while employment effects appear more variable (Brown et al., 2009; Cumming et al., 2007; Gilligan and Wright, 2010; Kaplan and Stromberg, 2009). In the light of the academic and policy debate, it is timely to provide systematic evidence on the impact of the recent global recession on highly-leveraged companies. In this study, we assess the economic and financial performance of virtually the entire population of U.K. PE-backed companies, for the period 1995–2010. We control for a wide range of firm-specific, industry and macro-economic factors that have been found to explain differences in performance, in an effort to isolate the impact of PE involvement.

More specifically, we examine the following research question:

Do PE-backed buyouts outperform non-buyout private companies and publicly public companies prior to and during the recession period in terms of growth, efficiency and profitability?

2. Private equity and buyouts

PE firms become active investors in many buyouts because they assume a seat on the board of directors and specify contractual restrictions on the behavior of management (Acharya et al., 2009b). They also benefit generally both from detailed pre-purchase due diligence and full, timely information on the current trading of the businesses in which they invest. Their expertise in monitoring may enable portfolio firms to improve performance through exploiting opportunities for both cost efficiencies and growth. PE involvement may also enable timely restructuring if portfolio companies experience trading difficulties and/or problems in servicing financial structures that could reduce the likelihood of failure (Pawlina, 2010). Non-PE backed firms, whether private or publicly public, may be disadvantaged in these respects.

The precise form of any buyout may vary, in terms of the role of incumbent management. A management buyout (MBO) usually involves a PE acquisition in which the existing management assumes a substantial proportion of the equity, which may be a majority stake in smaller transactions. Management may proactively undertake an MBO to generate financial gains through efficiency improvements, which might have been impossible to achieve under the previous ownership regime (Wright et al., 2000). However, managers may also engage in high risk activities in the absence of close monitoring. Some managers may also become involved in a buyout in order to protect their jobs. As incumbents, management may have superior information to outsiders but their objectives, motivations and competencies may mean that this is overvalued. Thus, management may overpay and/or be more likely to take actions to entrench themselves in the business with the consequence that they fail to take sufficient actions establish the viability of the firm. Management buy-ins (MBIs) entail greater risks, as incoming management do not have the benefits of the insiders' knowledge of the operation of the business (Robbie and Wright, 1995). Therefore, we expect MBIs to be significantly more likely to fail.

High leverage, meanwhile, places pressures on managers to perform, in order to be able to service the debt taken on by the company during acquisition. Although low borrowing costs are associated with high leverage (Axelson et al., 2010), very high levels of leverage may create problems in servicing the debt. This is especially true if cash flow projections are not met and predicated asset

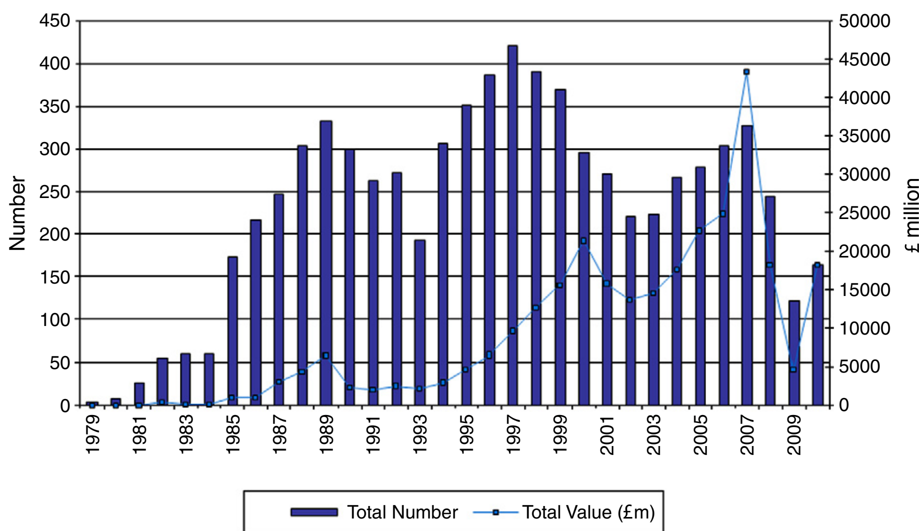

Fig. 1. UK private equity backed buyouts. This chart shows the trend in PE backed buyouts in the UK from the start of market development to the latest available annual data. The data included in the charts has no lower size cut-off.
Source: CMBOR/Barclays Private Equity/Ernst & Young.

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