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Do private equity owners increase risk of financial distress and bankruptcy?☆

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ABSTRACT

In this study, we investigate financial distress risks of European companies around the buyout event in the period between 2000 and 2008. In addition, we analyze whether buyout companies go bankrupt more often than comparable non-buyout companies. Our results suggest that private equity investors select companies which are less financially distressed than comparable non-buyout companies and that the distress risk increases after the buyout. Despite this increase, private equity-backed companies do not suffer from higher bankruptcy rates than comparable non-buyout companies. In fact, when companies are backed by experienced private equity funds, their bankruptcy rates are even lower. These findings indicate that experienced investors are better able to manage distress risks than their inexperienced counterparts.

Some financial investors do not waste any thoughts on the people whose jobs they destroy. They remain anonymous, do not have a face, pounce upon companies like swarms of locusts, graze on them and continue on their way. We are fighting against this form of capitalism.

Franz Muentefering, former chairman of the Social Democratic Party (SPD) in Germany (in an interview, Bild am Sonntag, 17 April 2005)

1. Introduction

There is some controversy regarding the key sources of success in the private equity (PE) model. Does this success come from value creation or from value transfer? Most scholars agree that PE investors create value by increasing productivity and profitability of their portfolio companies (e.g., Davis et al., 2008; Harris et al., 2005; Kaplan, 1989; Lichtenberg and Siegel, 1990, or Smith, 1990). Starting with Jensen (1986 and 1989) many researchers argue that these improvements result from a superior governance model that PE investors implement in their portfolio companies. An essential part of this superior governance model is a disciplining role of debt. Debt prevents managers from wasting resources, i.e., from excessively investing free cash-flows in projects with negative net present values, because the managers are forced to repay the loans.

Some scholars point out potential negative effects of debt level increases in buyout companies and argue that PE investors rather transfer value from other stakeholders than create it. Higher debt levels boost tax shields, which raise PE returns (Guo

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et al., 2011) and represent a transfer from taxpayers. Moreover, anecdotal evidence suggests that it is not uncommon for PE investors to increase debt levels in order to pay out special dividends for themselves (dividend recaps), which may be viewed as a transfer from other shareholders.[1] In addition, increases in debt levels could induce a higher risk of financial distress and bankruptcy (e.g., Kaplan and Stein, 1993), harming other shareholders and debtholders. Finally, PE investors may transfer value from the "financial system", as increases in bankruptcy rates may negatively affect financial institutions providing transaction financing. Policy debates are often led by concerns about harmful effects of excessive debt levels, increased financial distress risks and bankruptcy rates in companies which undergo buyout transactions and by concerns about potential broader negative implications on financial institutions and the stability of the financial system when large buyout credits fail.

We contribute to this discussion by investigating financial distress risk and bankruptcy rates of European companies around their buyouts in the period 2000–2008. Thus, we add to a growing literature documenting the real effects of PE financing. We shed some light on the potential negative effects of PE financing, whereas the existing literature predominantly focuses on the positive side of PE financing, such as links between PE investment and operating performance (e.g., Davis et al., 2009; Guo et al., 2011; Kaplan, 1989), PE investment and employment (e.g., Cressy et al., 2007; Davis et al., 2008, 2009; Lichtenberg and Siegel, 1990) or PE investment and innovation (e.g., Lerner et al., 2011; Popov and Roosenboom, 2009). Our research is also related to the recent literature that investigates how debt market conditions affect the capital structure in PE transactions. Axelson et al. (2010) find that when debt market conditions are favorable, PE investors increase debt levels. We add to this strand of research by analyzing whether companies subject to buyouts in favorable debt market conditions face a higher risk of bankruptcy than comparable non-buyout companies or than companies that are subject to buyouts in less favorable market conditions.

Our paper is also related to a vast literature addressing the issue of how syndication behavior and investors' experience affect portfolio companies. It is a priori not clear how syndication and experience are related to financial distress risks and bankruptcy rates. Our research contributes to filling this research gap. As to syndication, syndicates are ready to invest in more risky companies and strategies than stand-alone investors (Filatotchev et al., 2006) on the one hand. This may result in higher bankruptcy rates of companies backed by syndicates. On the other hand, syndicates are endowed with more resources than stand-alone investors. They can use these resources to prevent their portfolio companies from experiencing financial difficulties. If the latter effect prevails, we will observe lower bankruptcy rates in companies backed by syndicates.

As to experience, there are at least three arguments for why we expect experienced PE investors to be associated with lower financial distress risks and bankruptcy rates. First, an inexperienced investor may want to "show up" by investing in more risky companies and strategies, which possess a higher upside potential, but which more often end in financial distress and bankruptcy. Second, experienced investors have better know-how and instruments to avoid bankruptcy than inexperienced investors. One of the essential reasons is that they have easier access to loans (e.g., Demiroglu and James, 2010; Ivashina and Kovner, 2011). Third, experienced investors want to maintain their reputational stake vis a vis their capital providers and vis a vis financial institutions, which provide debt financing. Therefore, they have more incentives to avoid bankruptcy than inexperienced investors with a lower reputational stake. But there is also at least one argument in the opposite direction. Experienced investors may be better able to transfer value, for example through dividend recaps, because, compared to inexperienced investors, they have greater bargaining power, better negotiation skills and superior information, which may increase the risk of financial distress and bankruptcy in their portfolio companies.

Another contribution of our paper is that we provide a more comprehensive picture of the real effects of PE financing than many other existing studies, which often analyze investors or companies from a single country or which focus on listed companies only. In contrast to most of the aforementioned studies, our study includes several countries and we collect data on privately held companies. In addition, our sample including information on a large number of buyout as well as non-buyout companies and the pre- and post-buyout characteristics of the former group makes the identification of a causal effect more compelling than in most previous studies. To take into account that PE targets are not randomly chosen, we employ a matching procedure, a panel approach with firm fixed effects, and, finally, an instrumental variable approach.

We start with a sample covering more than 8 million companies from 15 countries. From this sample, we consider all buyout transactions and select comparable control firms. We focus on European transactions within the time horizon 2000–2008 because since the beginning of the new millennium, PE transactions have spread more and more throughout Europe. According to Kaplan and Strömberg (2009), 49% of the target enterprise value in buyout transactions were concentrated in Europe, compared to 44% in the US and Canada during the period 2000–2004. A more technical reason for our focus on European companies is that we need accounting data for these companies in order to measure their financial distress risk. Unfortunately, most PE transactions involve privately held companies, which are not required to disclose financial information in the US. In contrast, European companies have relatively stringent disclosure requirements.

Our results suggest that PE investors select firms which have a lower financial distress risk than comparable non-buyout companies and that the financial distress risk increases after the buyout transaction. However, the financial distress risk in buyout companies does not exceed the distress risk in comparable non-buyout companies three years after the buyout. In addition, our findings indicate that buyout companies do not suffer from bankruptcy more often than comparable non-buyout companies. This

[1] The Wall Street Journal reports that between 2003 and mid-2006, US PE-backed companies raised USD 69 billion additional debt "primarily to pay dividends to private equity owners" (Greg Ip & Henny Sender, Private money: the new financial order, Wall Street Journal, 25 July 2006, p. A1). An example of such a transaction is the case of Debenhams. This company was taken private in 2003 by a syndicate of CVC, Texas Pacific Group, and Merrill Lynch Private Equity with a package comprising approximately £1.4 billion of debt and £600m of equity. It was twice refinanced with debt. As a consequence, debt increased to £1.9 billion. These refinancings allowed £1.2 billion (twice the original equity stake) to be "taken out of Debenhams" and returned to the PE syndicate as a "special dividend" (Jonathan Braude, Debenhams to make debut, TheDeal.com, 21 April 2006).