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Private equity leveraged buyouts in European telecoms: The case of Eircom

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ABSTRACT

Highly leveraged buyouts (LBOs) of former state owned telecoms operators by private equity groups have occurred in a number of countries in recent years. This paper examines the case of Eircom in Ireland which has experienced five changes in ownership since full privatisation in 1999, two of which were LBOs. Enormous increases in Eircom's debt levels as a result of the LBOs resulted in the company's bankruptcy in 2012. This paper argues that this outcome was largely attributable to the short-termist strategies adopted by the private equity groups that assumed ownership of the enterprise. These strategies included high leverage, cash extraction and underinvestment in the fixed-line network which contributed to the demise of the enterprise and had wider economic and social effects. The Eircom case demonstrates the risks attendant to ownership of important network infrastructure by private equity groups and the need for regulatory safeguards to protect the public interest.

1. Introduction

In May 2012, Ireland's former state-owned national telecommunications operator Eircom went into bankruptcy.[1] This was the biggest case of corporate bankruptcy in the history of the Irish State to date and represented the culmination of a series of events that followed full privatisation in 1999. These included five changes of ownership, two of which were highly leveraged buyouts by private equity firms in 2001 and 2006. These buyouts resulted in the build-up of an unsustainable level of debt which severely undermined the company's financial performance but also limited its scope for investment in telecommunications infrastructure to the detriment of Ireland's export-led economy.

This article examines events at Eircom following privatisation. It focuses on the issue of highly leveraged buyouts and questions their suitability in the case of important network industries such as telecommunications. It argues that the case of Eircom serves salutary lessons for other economies faced with decisions in relation to the privatisation of network infrastructure operators.

2. Background: The privatisation of Eircom

The experience of Ireland in relation to developments in the telecommunications sector was very much in line with that of Western Europe up until 2001. Prior to 1983, Ireland's telecommunications service was run by the civil service.

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[1] In more precise terms, Eircom was placed in examinership in May 2012. Examinership is a formal process in Ireland that facilitates the restructuring and survival of an insolvent company while under the protection of the High Court.

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Following the recommendations of a review group, the operation of the telecommunications service was corporatised and transferred to a commercial state-owned enterprise, Telecom Éireann, in 1984. In 1996, 20 per cent of Telecom Éireann was sold to the Comsource consortium—consisting of Sweden's national operator, Telia, and the Netherland's national operator, PTT Telecom (later KPN)—as part of a strategic alliance. Comsource also acquired an option that entitled it to increase its shareholding to 35 per cent in the future. The establishment of the strategic alliance paved the way for full privatisation which was completed in July 1999. The final sale consisted of the allocation of a 14.9 per cent block shareholding to employees as part of an employee share ownership plan (ESOP) and the flotation of the company (and the government's remaining 50.1 per cent stake) on the stock market under the new name Eircom.

Privatisation was followed by a number of key events which further altered the structure and ownership of the former state-owned utility[2]. The principal events were:

- the demerger and sale of Eircom's mobile phone subsidiary, Eircell, to Vodafone in May 2001;
- the highly leveraged buyout of the remaining fixed-line business in December 2001;
- the re-flotation of the company in 2004;
- the second highly leveraged buyout of the company in 2006;
- the sale of the company to the state-owned Singapore Technologies Telemedia in 2010;
- the takeover of Eircom by creditors in 2012 after going into examinership.

Of the changes, the takeovers in the form of highly leveraged buyouts (LBOs) by private equity groups (PEGs) had the biggest impact on the financial and economic performance of Eircom after privatisation. The LBOs in 2001 and 2006 resulted in enormous change to Eircom's capital structure and the strategies pursued by the company. Moreover, as Eircom remained the dominant incumbent fixed-line operator in the Irish telecommunications sector the LBOs had negative wider effects on a sector which is of major importance to the Irish economy.

The paper is structured as follows: the next section briefly outlines the objectives and strategies generally adopted by PEGs that execute leveraged buyouts. The arguments supporting LBOs are discussed and the evidence regarding the impact of LBOs on target companies over the last 30 years is reviewed. We then turn to the question of increased leverage in infrastructure industries including telecommunications. The paper proceeds to focus on the impact of the two LBOs of Eircom before briefly comparing the Eircom experience to that of TDC in Denmark, the only other EU15 telecoms operator to have experienced an LBO. We conclude with a discussion of the implications of the Eircom experience for governments and regulators faced with future decisions in relation to the ownership of network industries.

3. Extent of private equity LBO activity and increased financial leverage in infrastructure industries

In general, the objectives and strategies adopted by PEGs executing LBOs share common features. The principal objective of such new owners is to maximise short-term profits rather than invest in the long-term growth of the target firm. Such private equity LBOs usually involve a small group of investors that provide approximately 20 per cent of the equity required to purchase the target firm, with the remaining funds made up of debt financing secured on the assets of the target firm. The new owners then generally recoup their equity investment by restructuring the target firm, extracting cash from the business and reselling the firm, typically within 3–5 years.

PEGs that execute LBOs generally attempt to, *inter alia*, raise debt financing levels of the target company to the point where the corporation tax deductibility of the interest expenses reduces taxes to a minimum, reduce the levels of operational expenses, and reduce capital investment levels to the minimum level required for continued operation, all of which allow for the maximising of short-term cash flow for payouts to investors. The change in the target firm's planning horizon to a short-term focus on cash generation and debt management can have significant implications for the long-term growth of the firm (Appelbaum & Batt, 2012; Melody, 2007, 2008a,b).

The popularity of the private equity leveraged buyout investment model has gone through multiple phases in the past three decades. Kaplan and Strömberg (2009) show how the value and number of leveraged buyouts (LBOs) peaked in the late 1980s, fell during the early 1990s, rose and peaked in the late 1990s, fell in the early 2000s and then experienced explosive growth from 2004 onwards. A significant proportion of private equity buyout activity took place after 2000, particularly in the period between 2005 and mid-2007 just prior to the global financial crisis. While the majority of LBO activity by PEGs took place in North America in the 1980s and 1990s, buyouts spread rapidly to Western Europe by the turn of the century. Between 2000 and 2004, 48.9 per cent of global LBO transaction value ($1.055 trillion) took place in Western Europe, with the region also accounting for 45 per cent of the $1.56 trillion total transaction value generated between 2005 and mid-2007 (Kaplan & Strömberg, 2009: 127–8).

Private equity investment in firms has long been controversial, particularly when it involves leveraged buyouts or financial engineering strategies. At a theoretical level, Jensen (1986) proposes that there are significant benefits in going private and LBOs. He argues that this is due to the control function of debt. "Debt creation without retention of the proceeds of the issue, enables managers to effectively bond their promise to pay out future cash flows […] Thus debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers"

[2] For a full description of the post-privatisation experience of Eircom see Palcic and Reeves (2011a).