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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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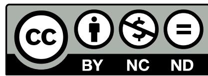

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5. Moral Hazard

> [...] the Fed estimates that corporate debt has risen from $3.3tn before the financial crisis to $6.5tn last year.
>
> Much of this debt has financed mergers and acquisitions and stock buybacks. [...] they boost earnings per share by shrinking the company's equity capital and thus inflate performance related pay. Yet this financial engineering is a recipe for systematically weakening balance sheets. (Plender 2020)

> Excessive leverage is the juice that enables businesses to privatize gains and socialize losses. (Fleischer 2020)

Magnifying Earnings with Debt Finance

The arithmetic of inflating performance-related pay by raising gearing with a debt-financed merger is simple, and we doubt whether many readers need any explanation. Just as putting a vehicle into a higher gear leads to more revolutions of the wheels for given revolutions of the engine, so higher gearing of the business typically leads to more earnings per share (EPS) for given operating profits.

As in Chapter 3, we draw on the case of Belgium-based AB Inbev's 2016 acquisition of fellow beer business, South Africa-based SAB—here to illustrate the arithmetic of debt-funded acquisition. The deal gave the merged firm control of over 2,000 beers and a powerful position in the US and other markets.[1] Their respective financial statements show that before the acquisition AB Inbev, the acquirer, had a gearing ratio, g (the ratio of borrowing to the sum of equity and borrowing), of 0.5 (rounded); for the target, SAB Miller, the ratio was roughly 0.3. But after the acquisition was completed, the ratio for the combined business had risen to 0.6, the deal having been supported partly by a syndicated loan

1 Tepper and Hearn, p. 188; Wu, p. 117.

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of $75 billion. As the two firms enjoyed returns on net assets[2] before the deal exceeding 10%, and were able to borrow at around 3% (SAB Miller 2016, p. 4), this increased indebtedness is likely to have enhanced the return on equity,[3] and earnings per share (EPS), albeit at the cost of increased risk. The improvement comes from borrowing money at 3% and investing it at, say, 10%,[4] without there needing to be any improvement in the operating profit generated by the firm's assets. EPS could increase even if operating profits declined. We noted in Chapter 3 the disappointing financial outcome of this merger.

Limited Liability and Moral Hazard

Other things equal, the smaller the equity cushion, the higher are EPS. But this 'weakens balance sheets': the business is less able to weather losses in adverse conditions (e.g. a pandemic) and avoid insolvency. However, limited liability (the norm for businesses) reduces the downside for shareholders and strengthens the incentive to take on borrowing: it means that if the business fails, the most the shareholders can lose is their own stake in the balance sheet (their initial subscription of equity plus any earnings retained by the business on their behalf). If the firm becomes balance-sheet insolvent (their assets are less than their liabilities—'negative equity'), the equity shortfall hits other stakeholders in the business: lenders and others owed money by the business will not get all they are owed. There is 'moral hazard'—the borrower shifts some of the downside costs of risk-taking and so has an incentive to take on extra risk for the sake of potential gain.

Contrast this privilege with the typical UK home-buyer's unlimited liability when she combines her funds (a deposit—her equity) with a mortgage from the bank. If she has to sell the house and its value has fallen below the mortgage outstanding (she has 'negative equity') she has to make good the deficit: unlike equity-holders in a limited liability company, her obligation is not limited to the equity she committed.

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2 Earnings before interest and taxation (operating profits), divided by (the sum of equity and non-current liabilities).

3 Earnings after interest and tax, divided by equity.

4 Where the buyer pays more than book value for the target (the usual situation), the return on the newly acquired assets will of course be less than 10%.

The slender equity stakes contributed by acquirers in some deals is illustrated by Walmart's sale of Asda, their top-4 supermarket chain in the UK, at a valuation of £6.8 bn. Smith and Wiggins (2021) reported that 'The private equity backed billionaires buying Asda will pay less than £800m of their own money to take a controlling stake in the supermarket…' The rest was funded by borrowing, and by the proceeds of selling Asda assets and leasing them back. Their equity stake was just 12% of the purchase price, whereas 'on average, European leveraged buyouts had an equity contribution of more than 50% in 2020'.

Inevitably, smaller cushions of equity heighten the risk of failure. In analysing the eventual closure of Debenhams, the major UK department store chain founded in 1778 and operating 118 stores, Elder (2021a) discusses the role of the owners' 'over-enthusiastic cash-extraction' in earlier years. He recalls that:

> CVC, Texas Pacific and Merrill Lynch acquired Debenhams in 2003 in a 1.8bn pound leveraged buyout that needed just 600m of equity. The trio then extracted more than 1bn via property sale and leaseback arrangements and floated it [on the Stock Exchange] again for nearly the same price in 2006.

The earlier extraction of cash had left the business with diminished equity—reserves available to meet setbacks.

We discuss below some of the losers from the limited liability of borrowers. Professional lenders such as banks aim to protect themselves by demanding a premium in the interest rate that they charge—to compensate for the risk arising from the limited liability of the borrower. Also, they typically demand security—a first claim on certain assets of the borrower in the event of failure. And they incorporate covenants in their contracts, allowing them to intervene if performance flags—for example if interest cover (profit/interest) falls below a defined threshold.[5] However, the incidental 'lenders' we discuss below (trade creditors, members of a company pension scheme), are less able than banks to protect themselves from the consequences of limited liability. And this can lead to severe problems of 'moral hazard'. Some experts

5 Though the rich opportunities to flatter reported profits after merger via creative accounting (Chapter 9) can subvert this last safeguard in the case of M&A.

in this field have proposed that the limited liability of some corporate borrowers ought to be restricted (Goodhart and Lastra 2020).

Free Loans from Suppliers

Carillion offers a striking example of free 'loans' from suppliers as a funding source, documented in a UK Parliamentary Committee Report (HoC 2018). It grew through a series of mergers into one of the largest UK construction companies, operating in several countries. The monopsonistic power Carillion had achieved—partly though acquiring rivals—allowed it in effect to demand from its suppliers interest-free funding. As it turned out, this carried very high risk. Suppliers were pressed to agree to payment for their goods and services as late as 120 days from delivery, even though Carillion had joined the UK Government's Prompt Payments Code which targeted payment within 30 days, and stipulated that 95% be paid within 60 days (HoC, p. 40). This arrangement obviously increased the amount Carillion owed to suppliers at any one time. And when Carillion failed (in 2017–2018) it owed around £2 billion to 30,000 suppliers, who would receive little from the liquidators, and some of whom were themselves bankrupted as a result. Carillion is analysed in detail in Chapter 11.

Free Loans from Pensioners

Members of companies' defined benefit pension schemes have sometimes unwittingly financed acquisitions of the companies for which they work. And they have in some cases suffered significant losses as a result, when the acquiring company went on to fail. The key features of such a process are illustrated by an acquisition documented in detail in another UK Parliamentary Committee Report (HoC 2016). Dominic Chappell's RAL (Retail Acquisitions Limited) acquired Sir Philip Green's retail chain, BHS (British Home Stores)—all the assets of this old-established national store chain—its properties, equipment, inventory, brand, etc.

How much did RAL pay? One pound. How come?

Sir Philip was a shrewd and very successful businessman, not someone you would expect to give away a retail empire for next to nothing. A key part of the answer lies in the defined benefit pension fund

for BHS employees. Such funds—now shunned by most private sector employers—arose from past contracts with employees to pay a defined pension throughout their retirement (Meeks 2017). The pensions were part of the remuneration packages—deferred pay—offered by employers. Year by year employers (and employees) paid contributions to a pension fund designed to meet these pension obligations. But BHS had failed to accumulate assets in its pension funds sufficient to meet its prospective pension obligations. When Sir Philip bought BHS in 2000, the pension fund's assets exceeded its prospective obligations by £43 million; when he sold it in 2015, there was a shortfall on some estimates of £350 million.

When Mr Chappell bought BHS in 2015, he took ownership of the company for a pound; but his company also assumed liability for these pension obligations. It was analogous with assuming responsibility for a loan to BHS from a bank, with this loan funding the entire operation—without any equity stake from the 'owners'. In effect, there was no material equity in the business. In the year following the acquisition Mr Chappell, who 'had a record of bankruptcy [...] and neither retail experience nor any experience of running a similar-sized company' (HoC 2016), oversaw a further decline in operating performance at BHS (the common post-merger pattern we documented in Chapter 1). Yet Mr Chappell's company extracted £11 million in fees from its BHS subsidiary and £6 million in loans, while he personally took £2.6 million in salary and fees (a pattern of executive behaviour familiar from Chapter 2) and an interest-free loan of £1.5 million, which was not repaid. In 2016, not long after Mr Chappell's purchase, BHS went into administration. 11,000 employees lost their jobs; and 20,000 current and former employees faced major cuts in their pensions: on one calculation, the pension fund deficit by then totalled as much as £571 million. The HoC Report encapsulates the moral hazard in this high-risk acquisition: 'The tragedy is that those who have lost out are the ordinary employees and pensioners'. In the end, Sir Philip Green, the vendor of the business, yielded to huge political and media pressure and paid £363 million into the pension fund—'likely to help the billionaire keep his knighthood' (Ruddick and Butler 2017); and the average employee lost 'only' 12% of her pension benefits.

This was an extreme version of moral hazard in funding an acquisition. The acquirer made in effect a one-way bet: if it came off, he won all the future earnings of BHS; if it didn't, he just lost his pound but the current and former employees lost some of their pensions.[6]

6 This is in addition to the adverse impact on employees' mental health of the acquisition process itself. Bach et al. (2021) provide statistical evidence of the mental health effects; Hill (2019, 2022) gives specific examples.