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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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7. Private Equity (PE)

> Private equity is all about risk. Funds are notorious for allowing their portfolio companies only a slim financial cushion to ride out economic downturns [...]
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> There have been many examples of funds risking a thin sliver of their own money as equity, providing the rest of the finance their companies need with debt and then walking away from investments that go wrong. Many have paid themselves big dividends from increased debt [...] Pension funds and others often pay high fees for what they are told is better management on behalf of the industry. (*FT Leader* 2020a)

Serial acquisition such as the conglomerate GE had practised has in recent years been increasingly supplanted by private equity (PE) firms. GE—which acquired around a thousand businesses in the last two decades of the twentieth century—has more recently been divesting businesses and finally breaking itself up into specialist firms. But private equity funds have been expanding their activities. There were nearly 7,000 private equity firms in the US in 2019. Even in Europe, they have accounted for almost 40% of M&A volumes recently, over half of those deals in the UK. Their individual scale is illustrated by one of the pioneers of the PE industry, KKR, which has bought some 400 companies since its foundation in 1978, at a cost of $650 bn; and its portfolio of companies employs over 800,000 people (Vandevelde 2021).

At first sight a PE business looks like a traditional conglomerate. But there are some significant differences. For example, PE businesses generally run funds with a limited life: their acquisitions are reorganised and sold after a few years, the proceeds distributed to the subscribers. Conglomerate acquirer GE, by contrast, was a continuous member of the Dow Jones Industrial Index from 1886 to 2018 (Dissanaike et al. 2022). Then, whereas GE has generally been headed by an industrialist promoted from within the company, KKR was led by three former

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employees of the investment bank Bear Stearns. And the typical business model of PE executives has differed from the traditional conglomerate in the way they have managed acquired businesses, in their use of financial engineering, and in their incentive schemes for the top management.

Managing Acquired Businesses

One source of gain sought by PE has been to mitigate the principal-agent (or ‘stewardship’, or ‘governance’) problem associated with public companies run by salaried managers and owned by dispersed, remote shareholders. Concentrating ownership in the PE fund removed the free-rider problem in a public company, where, with large numbers of shareholders, individual shareholders would devote limited effort to monitoring and disciplining management when most of the benefits went to others. And the PE arrangement mitigated some of the information problems to be discussed in Chapter 9: shareholders in public companies are only entitled to the information mandated by law and the regulators, while the PE firm could demand whatever information they deemed necessary to monitor and guide the acquired business.

And then, the individual acquired companies in the PE portfolio have been funded with very high levels of borrowing, designed to strengthen incentives to generate profit and not to dissipate it in ways discussed in Chapter 2. This debt creation ‘[...] enables managers [of the acquired businesses] to effectively bond their promise to payout future cash flows’ (Jensen 1986). If they failed to meet the interest and principal payments they would end up in bankruptcy court. And, in Jensen’s words: ‘These transactions are creating a new organizational form that competes successfully with the open corporate form because of advantages in controlling the agency costs of free cash flow’ (p. 325).

Financial Engineering

As well as sharpening the incentives facing managers of the acquired businesses, heavy reliance on debt funding could bring additional benefits discussed in Chapters 5 and 6: magnifying the returns to equity holders, securing tax breaks, and taking advantage of the government distortion of interest rates after the financial crisis. The increase in reliance on debt funding has been dramatic: 'financial debt of non-financial US firms [not just PE] has grown 30-fold in the past 50 years...' (*FT Leader* 2021). Chapter 5 reported on a recent acquisition in the UK—of food retailer Asda—where the equity subscribed by the buyers (the Issa brothers and PE fund TDR Capital) totalled just £780 million of the purchase price of £6.8 billion. (Lex 2021)

Chapter 5 discussed the benefits to equity-holders of limiting their stake in the business, outlining the arithmetic of debt finance—the attractions of borrowing at, say, 3% to buy assets yielding 10%. If the business performs well, earnings for equity are inflated by heavier reliance on debt finance. If it performs poorly, limited liability provisions mean that equity-holders lose only their stake. Other interest groups (sometimes unwittingly) can bear most of the downside costs. Ford (2019) provides an illustration:

> Toys R Us, the US retailer [...] fell into liquidation last year after more than a decade of private equity ownership [...]
>
> Investors lost the slender equity stakes they had contributed [...] But it was far worse for the workforce. Tens of thousands not only lost their jobs, but their entitlement to severance pay as well.
>
> The private equity firms later made a $20m payment into a workers' hardship fund to try to quell the ensuing rumpus (staff representatives claimed they were owed $75m). But that just served to highlight the disparity between what the buyout bosses felt they owed and what they had extracted. Over the 12 years of the buyout, they had banked riskless management fees of $470m.
>
> Toys R Us is far from the only example of this sort of 'heads I win, tails you lose' capitalism.

As Chapter 5 discussed, borrowing brings the further benefit that the interest payments are typically deductible in the calculation of corporation tax. Then, since the financial crash of 2008, the opportunities for financial engineering have been further reinforced by central banks' interventions to force interest rates below the level they would reach in a free market. Wiggins (2020b) commented: 'The US Federal Reserve's decisions to cut interest rates to zero [...] ensured private equity's continued access to cheap debt for new deals [...] "Ultimately the lifeblood of private equity is cheap debt", said Bryce Klempner, partner at consultant McKinsey.' A later comment reinforced the point: 'They all think they're geniuses because their companies are doing really well', quoted Wiggins from one commentator, who went on: 'But if it weren't for central bank policy, things would be very different' (Wiggins 2021).

Easy access to debt has meant that the PE owners could extract large sums of cash without first making profit in their acquired companies. Rennison (2020) gives the example of snack foods maker Shearer's Foods, owned by Chicago-based PE company Wind Point Partners and the Ontario Teachers' Pension Plan: 'It raised more than $1billion in the loan market on Tuesday, in part to fund a $388m payment to its owners, according to ratings agency Moody's.'

The importance of the financial engineering motives for PE acquisitions, rather than stimulating stronger operating performance in the acquired business, can be inferred from commentary on the acquisition of the UK food retailer Morrisons by Clayton Dubilier and Rice, the US private equity group. The acquirer's adviser, Terry Leahy (a leading expert on the industry), described Morrisons as already 'an excellent business with a strong management team, a clear strategy and good prospects'. And Eley (2021) reports that 'Analysts have questioned how any owner will be able to generate a return on such an outlay on Morrisons without big asset disposals.'

Incentives for Top PE Executives

Chapter 2 focused on the misalignment of incentives facing the top executives of traditional (non-PE) acquiring businesses. Many benefits accrue to those executives whether or not an acquisition enhances operating performance; and efforts to link their pay to performance have been criticised as too weak (Jensen and Murphy 1990), or because they were too easily subverted by creative accounting—or indeed by distorted financial engineering. The PE industry has responded to these challenges by linking investment managers' benefits more securely to those of the external investors, redesigning the system of incentives and making them much more powerful. The PE firms may manage a number of PE funds, each with several investments in their portfolio. The funds buy and sell businesses, and are typically liquidated after around five to seven years. The PE firms receive management fees of up to 2% of the funds' assets. In addition they receive a performance fee—up to 20% of the fund profits[1]—a very direct alignment of interest.

As mentioned in Chapter 6, the benefits for the PE managers are further enhanced by another tax privilege. The profits (confusingly called 'carried interest', or 'carry' for short) are taxed at lower rates than, say, salary. Philippon (2019) reports that in the US, carry qualified for a capital gains tax rate of 23.8% rather than an ordinary income tax rate of up to 37 percent (p. 221). In 2020 an *FT* Leader explained that carry was also taxed as capital gain in the UK, the rate then being 28% rather than the 45% top rate of income tax. 'The result has been to foster a generation of buyout billionaires who have paid lower tax rates than their cleaners.' (FT Leader 2020b)

The relatively high power of the incentives for the PE managers can be compared with the rewards for a leading practitioner of the old conglomerate acquisition model. Mr Welch,[2] CEO of GE for twenty-one years, is estimated to have received between $450 mn and $800 mn over his whole employment by GE (Gryta and Mann 2020, pp. 319–20). He was head of the biggest company in the world, and 'Manager of the Century'. But his compensation does not come close to that of the 23 PE billionaires reported by Phalippou (2020), not counting the prospective billionaires whose gains have not yet all crystallised: 'the estimated total performance fee [carry] collected by these funds is estimated to be $230 bn, most of which goes to a relatively small number of individuals', notes Phalippou.

Phalippou (2020) provides a revealing analysis of the distribution of gains from one fund created by Blackstone, a leading US private equity business:

> An investment made by a 2006 vintage fund generated $2.6bn of carry for the PE firm (plus at least $685mn of management fees), $150mn for the CEO ($100mn for rest of senior management), $5bn for selling shareholders and $470mn of direct acquisition costs (plus other professional service fees).

Does this mean that PE's new model—combining tighter supervision of the managers of acquired businesses with the fruits of financial

1 Sometimes a percentage of profits above a threshold.
2 The 'Neutron Jack' of Chapter 1.

engineering (distorted by limited liability, tax breaks and a rigged debt market), and with the enhanced incentives (and privileged tax) for executives—overturns the statistical finding that makes the rapid growth in merger activity since the 1970s so mysterious—the failure of most mergers to enhance performance? Phalippou's analysis of the performance of the PE industry more generally suggests not. He concludes that 'Private Equity funds have returned about the same as public equity indices since *at least* 2006.' The structure of PE deals and resultant gains to various stakeholders clearly create an incentive to engage in M&A activity. But it is not clear whether the PE model has typically produced operating gains. PE firms have responded to Phalippou's findings with indignation, claiming that other performance measures show them in a more favourable light. But Phalippou has provided a compelling critique of alternative measures such as the internal rate of return, noting that '[i]n a complex environment riddled with multiple layers of agency conflicts, misleading information can and does proliferate.' The next chapters explore information problems in the wider M&A market which help perpetuate mergers that yield no gain in operating performance.

Section C

Information Asymmetry

Incomplete information or misinformation afflict the M&A process in a number of ways. The limited information available to stock investors can give rise to volatility in share prices, more than is warranted by the variation shown in the subsequent earnings they are supposed to represent. Acquirers may take advantage of unwarranted increases in the price of their own shares, which enable them to buy a target with those inflated shares—a bargain. Or again, if management know that the stock market, based on its limited information, is undervaluing a potential target they have the opportunity to make a capital gain by acquisition. In neither case has the motive anything to do with increasing operating profit (Chapter 8). Then, when outsiders do not enjoy access to the same information as the insiders, executives of would-be acquirers can engineer a higher share price by creative accounting: again, they can benefit from an acquisition which offers no operating gains (Chapter 9). The same outcome may be achieved by issuing biased earnings forecasts of the earnings the combination would achieve after merger—to inflate the price of shares offered in exchange for the target. Once the deal has been agreed, the accounting procedures for combining the accounts of the two firms have offered rich opportunities to flatter the earnings reported post-merger (Chapter 9). These procedures can help sustain a feedback loop, where inflated earnings facilitate a merger which offers further opportunities to flatter earnings, setting the scene for another deal... (Chapter 10). Finally, if the merger fails badly, accounting regulations sometimes leave sufficient flexibility for the CEO who led the merger to conceal the damage, or for his successor to exaggerate it (Chapter 9).