AFR Americans for Financial Reform

Toys “R” Us and Taking on Private Equity Predation

In March 2018, retailer Toys “R” Us announced it was liquidating, and laid off its 33,000 workers. In a letter to employees, Toys “R” Us said that, because of its financial condition, it would not pay severance to employees upon closing its doors for good on May 14.[1]

Toys “R” Us is the latest in a string of companies that have filed for bankruptcy and laid off workers following leveraged buyouts by private equity firms. Other examples include Sports Authority, Remington, iHeartMedia, Payless, Caesars Entertainment, Hostess Brands, Energy Future Holdings, and Gymboree.[2]

The structure of leveraged buyouts and private equity’s aggressive use of debt and other methods of draining value from companies creates a “heads I win, tails you lose” scenario. Private equity owners are incentivized to drain capital out of the companies they own. Employees, creditors, and other stakeholders bear the consequences if the firm fails, while the private equity owners most often still walk away with gains. What’s more, private equity owners are often able to get tax benefits for this business model by taking advantage of the carried interest tax loophole, which allows them to pay a lower tax rate on their own profits than ordinary workers are required to pay on wages.

Fueled by cheap credit, the private equity industry and business model has grown massively over the past decade. Assets held by private equity firms have grown from $1 trillion prior to the financial crisis to a new record of $5.1 trillion in 2017.[3] Today, companies owned by private equity employ more than 11.3 million workers.

Private Equity and Toys “R” Us

Toys “R” Us was purchased by private equity firms Bain Capital and KKR, along with Vornado, a real estate investment trust. Bain Capital, KKR, and Vornado took Toys “R” Us private through a leveraged buyout in 2005. As is almost always the case in such transactions, the acquiring private equity companies forced the target company, Toys “R” Us, to borrow the money for its own buyout. This added over $5 billion in debt to Toys “R” Us’ balance sheet.[4] The company was valued at $6.6 billion at buyout, so this meant that the post-buyout firm had almost 80% of its value in debt. The newly assumed debt was over 7.5 times the company’s earnings before depreciation, interest, and taxes.[5]

Paying interest on the massive amount of debt loaded on to the company in the buyout greatly reduced the company’s flexibility in case of a downturn in earnings, and also reduced its ability to invest in its own future. However, the massive debt loaded on the company was not the only

way that these private equity firms extracted value. KKR, Bain Capital, and Vornado collected more than $470 million in fees and interest payments from Toys "R" Us over the last several years.[6] Much of this amount was "monitoring fees" paid directly to the private equity firms for services that remain unclear.

When retail demand for Toys "R" Us products did decline, the company was heavily burdened with debt and had paid out much of its past revenues to private equity firms. As a result, it could not adjust to changes in the market and could not successfully restructure. As the CEO of Toys "R" Us stated at the time of the bankruptcy, "The Company's overleveraged capital structure has constrained it from making necessary operational and capital expenditures, including investing in the revitalization of stores."[7] Even before the company's bankruptcy, employment at Toys "R" Us had declined from 60,000 employees at the time of the private equity buyout to 33,000 today.

As things stand now, 33,000 workers are losing their jobs when the company is dissolved and they are not getting any severance pay. However, the private equity firms who bought Toys "R" Us turned a profit on their ownership, thanks in large part to the $470 million in interest and fees they took from the company before the bankruptcy. And, since creditors of Toys "R" Us have no recourse to the private equity firm itself, the private equity owners are not liable for the company's debts.[8] **The $470 million paid to private equity owners would be enough to pay over $14,000 in severance to each employee who is losing their job.**

Addressing Private Equity Predation

Unfortunately, the story of Toys "R" Us is hardly unique, and it is likely to become even more common during the next recession, when companies burdened by private equity debt and fees cannot adjust to the downturn. At that point, many of the over eleven million workers employed by private equity-owned firms might unfortunately join Toys "R" Us workers in the unemployment line, especially if no changes are made.

There are many steps policymakers concerned about the dangers of private equity abuses can take, including eliminating the carried interest tax benefit for private equity owners and improving transparency for private equity activities. Below we outline a set of approaches focused on addressing the core parts of the private equity business model that contribute to bankruptcies and harm workers:

Limit the extent to which private equity firms can drain value from target companies

The private equity business model relies on a "heads I win, tails you lose" approach where private equity firms guarantee that they will profit regardless of the eventual outcome for the target company. This approach generally involves loading the acquired company with debt, and charging a wide variety of fees to ensure that profits during ownership accrue to the private equity firm.

Government should limit the extent to which companies can be forced to borrow to finance their own private equity takeover. Fees by private equity firms, which are usually hard to associate with any concrete useful services provided to the company, should be classified as dividends or limited.

Empower other stakeholders, especially workers, to influence managerial decisions

When private equity firms take control of the internal management and ownership of the target company, they often subordinate the long-term interests of the company to the short-term interests of the private equity firm. Empowering other stakeholders whose interest is in the long-term success of the business is an important way to counteract private equity's short-term focus. Eliminating barriers that make it difficult for workers to form a union is the best way to empower workers. Any union at a company owned by a private equity firm should be highly attentive to whether the interests of the private equity owner are being prioritized over the long-term interests of the company, and should work to bring the private equity firm itself into negotiations that affect the future of the company.

If private equity-owned firms fail, provide recourse to the private equity firm, including clawbacks

Because the private equity firm is a separate corporation from the companies it owns, creditors of a failing company cannot pursue the private equity firm for any losses. This is despite the fact that the private equity firm has likely contributed to the bankruptcy by loading the company with debt and by draining funds from the portfolio firm through fees or other mechanisms to transfer value. However, once these funds are transferred, they are generally no longer available to the creditors or workers of the failed firm in the bankruptcy process. This should be changed by giving creditors and workers access to any resources transferred from a private equity-owned firm if that firm fails, in order to compensate them for losses suffered in the bankruptcy. This would make outcomes fairer if firms do fail, and would also reduce incentives to drain resources from the firm if such transfers endanger the continuing viability and health of the firm.

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[1] Eliza Ronalds-Hannon, Matthew Townsend, & Lauren Coleman-Lochner, "Behind the Breakneck Unraveling of Toys 'R' Us," *Bloomberg*, March 16, 2018, available at: https://bloom.bg/2FPb64H.
[2] See Chris Isidore & James O'Toole, "Hostess Brands closing for good," *CNN Money*, November 16, 2012, available at: https://cnnmon.ie/2rw8Hpo. Adam Lewis, "Buyer beware: Breaking down the carnage from 5 pre-crisis mega-deals," *Pitchbook*, April 6, 2018, available at: https://bit.ly/2IqZzwS. Andrew Flanagan, "iHeartMedia Turns The Dial To Bankruptcy," *NPR*, March 15, 2018, available at: https://n.pr/2HEiFeP. And, Alicia McElhaney, "Private Equity's Trail of Bankrupt Retailers," *Institutional Investor*, October 26, 2017, available at: https://bit.ly/2jHRohF.
[3] Danielle Ivory, Ben Protess, & Kitty Bennett, "When You Dial 911 and Wall Street Answers," *The New York Times*, June 25, 2016, available at: https://nyti.ms/2jbw8yg. Also see: *The rise and rise of private markets*, McKinsey & Company, February 2018, available at: https://mck.co/2I9nU6U.
[4] Marielle Segarra, "Toys 'R' Us and why retail downturn is all about debt," *Marketplace*, March 14, 2018, available at: https://bit.ly/2oO8Io6.
[5] From Toys "R" Us, Inc. 2005 Form 10-K, available at: https://bit.ly/2wkNowI.
[6] Ronalds-Hannon et al., "Behind the Breakneck Unraveling of Toys 'R' Us."

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[7] Declaration of David A. Brandon, Chairman of the Board and Chief Executive Officer of Toys "R" Us, Inc., In Support of Chapter 11 Petitions and First Day Motions filed by Michael A. Condyles of Kutak Rock LLP on behalf of Toys "R" Us, Inc., September 9, 2017, available at: https://bit.ly/2I13267.

[8] While the private equity firms did lend a small amount of money to the company as part of the initial buyout, this money has long since been paid back.