Americans for Financial Reform Education Fund

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Private Equity Industry Poised to Profit from the Federal Reserve's New Lending Programs

The private equity (PE) industry is known for a business model that involves purchasing companies, loading them with debt, and laying off employees, all while paying themselves large sums of money in dividends. This business strategy rests on using the shield of corporate immunity to avoid liability of the parent private equity fund for obligations of the portfolio companies they own, so that the private equity firm can impose debt upon or remove assets from its portfolio firm and face no accountability to creditors or stakeholders of the portfolio company.

This private equity business model is dangerous in normal times, but it is especially perilous during an economic crisis when large amounts of government financial aid is available. Private equity funds could access government assistance for their portfolio companies while avoiding any responsibility to repay any debt or obligations to the public purse. Private equity firms could also tap government aid to finance leveraged buyout purchases of additional companies, using taxpayer money to load target companies with debt and drain their assets while avoiding any responsibility for paying that debt back.

Private equity owned businesses were mostly ineligible for the Paycheck Protection Program (PPP) run by the Small Business Administration (SBA) due to the "affiliation rule" that excludes parent firms that control a company employing more than 500 employees across all its businesses. On the other hand, it seems clear that unless the rules are changed substantially, private equity *will* be able to draw large benefits from most or all of the Federal Reserve's lending facilities launched as part of the CARES Act. The multiple, combined Federal Reserve credit facilities that provide loans and other financial support to companies are much larger than the PPP program.

The Federal Reserve credit facilities have few limitations on size or type of companies that can access the financial assistance program, making it possible for private equity firms and private PE-owned companies to get taxpayer-backed aid. Although the programs were supposed to target viable but struggling firms, the Federal Reserve has expanded the eligibility criteria of some of the programs in ways that would allow more highly indebted companies owned by private equity firms to access them.

Many of these PE portfolio firms were financially precarious before the coronavirus economic downturn because of the PE-imposed high debt loads from leveraged buyouts, dividend payouts, and other asset stripping. The Federal Reserve credit facilities could end up subsidizing the PE business model that had already left these portfolio companies struggling instead of shoring up firms that were harmed by the economic effects of the coronavirus.

The large-scale use of public funding to finance private equity financial engineering during this crisis could be a disaster. There are currently vanishingly few conditions attached to receiving help through the facilities, so the PE firms can take advantage of financial aid without having to commit to use the money to retain workers, adhere to basic safety standards, or direct the funds to the sustainability of the firms through the crisis and beyond.

The Federal Reserve credit facilities created in response to the crisis include the following:

- Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF)
- Primary Dealer Credit Facility (PDCF) and Term Asset-Backed Securities Loan Facility (TALF)

- Main Street New Loan Facility (MSNLF), Main Street Priority Loan Facility (MSPLF), Main Street Expanded Loan Facility (MSELF)

We discuss private equity in relation to each of them below.

Primary and Secondary Corporate Credit Facilities (PMCCF and SMCCF)

The PMCCF and SMCCF programs are intended to purchase debt securities issued by corporations, both new issues and existing secondary market instruments, as well as shares in Exchange Traded Funds (ETFs) which in turn purchase the bonds and loans of struggling companies. But indebted private equity-owned companies that were already at risk of default before the crisis could access these programs, unfairly rewarding risky private equity business strategies. The Federal Reserve has outsourced the bond purchases under its Corporate Credit Facilities to BlackRock's Financial Markets Advisory group to purchase the loans or bonds of U.S. companies (and in some cases U.S. subsidiaries of foreign companies).

Generally, these purchases are aimed to buy bonds or loans with lower-medium investment grade ratings (rated BBB- or Baa3 by two rating agencies) as of March 22, 2020, benefitting private equity-backed companies meeting that criteria. But even if the bonds or loans became riskier and were downgraded after that date, BlackRock could still buy them as long as they are still rated above non-investment grade speculative (higher than lower-medium investment ratings of BB- or Ba3) by the time of BlackRock's purchase. Under the SMCCF, however, BlackRock's purchases can reach even lower-rated borrowers whose debt otherwise would not qualify for the program. The expansive eligibility for higher risk firms makes more PE-owned companies eligible, since portfolio firms are commonly laden with so much debt from leveraged buyouts and other distributions that their loans and bonds are riskier and bear lower ratings.

As part of its contract with the Federal Reserve, BlackRock is purchasing corporate bonds through exchange traded funds (ETFs are financial instruments that contain high-yield corporate bonds, corporate debt, and equities, among other things) to provide liquidity during the economic crisis. Many of these ETFs contain riskier bonds and loans of private equity-backed firms with even lower non-investment grade ratings. For example, if BlackRock were to purchase high-yield bond ETFs such as the iShares iBoxx Investment Grade Corporate Bond Fund or the iShares iBoxx High Yield Corporate Bond Fund contain many private equity backed borrowers with higher risk ratings (iShares also happens to be owned by BlackRock), the Fed would indirectly be supporting PE-backed firms with non-investment "speculative" or "highly speculative" ratings (ranging from B- to BB+), clearly below the lower end of the investment-grade threshold. The money from the CARES Act provided to the Fed could be exposed to many of these higher risk investments that are clearly not investment grade as its other corporate bond purchases must be.

The fact that the Federal Reserve is permitting BlackRock to buy these ETFs enables many private equity-backed firms to access taxpayer-backed financial assistance through a very opaque mechanism. Some of the PE-backed firms that could receive this an indirect benefit from these ETF purchases include the grocery store chain Albertsons-Safeway (owned by PE firm Cerberus and a debt rating of B+), retailer PetSmart (owned by BC Capital and rated B-), and the financial data and news group of Thomson Reuters (renamed Refinitiv by Blackstone and rated B).

Primary Dealer Credit Facility and Term Asset-Backed Securities Loan Facility (PDCF and TALF)

The Primary Dealer Credit Facility and Term Asset-Backed Securities Loan Facility are intended to strengthen lenders capacity to provide credit during the crisis (both primary dealer banks that already underwrite securities and debt as well as private funds that buy securitized term loans, including corporate collateralized loan obligations, auto loans, and other term loans). Under these credit facilities, the Federal Reserve would purchase tranches of the least risky, prime rated (AAA) loans or debt-backed securities, enabling the lender to extend more credit or buy more debt-backed assets.

The private equity industry is likely to be a big beneficiary of these credit facilities that are likely to support the issuance of more collateralized loan obligations (CLOs). About two-thirds of the debt behind CLOs are the higher-risk loans that finance private equity leveraged buyouts of portfolio companies. When the Federal Reserve buys or securitizes the prime rated CLO tranches, it reduces the total cost to issue CLOs, since these AAA CLOs represent about 60% of the financing costs.

The Fed's credit facility cost subsidy enables CLO issuers to purchase even riskier leveraged loans and high-yield bonds (which cost more), which in turn supports the primarily private equity firms that rely on this debt. Since the Fed's credit facility reduces the CLOs financing costs, the CLO can provide cheaper funding for private equity-backed debts making it easier for the PE firms to take over companies, use debt-backed dividend payments, or engage in other PE financial engineering.

The TALF program operates similarly except with the two key stipulations that any fund with a relationship with a primary dealer bank (for example, BlackRock, PIMCO, or AllianceBernstein) can receive a loan to purchase AAA rated tranches of CLOs with a "static portfolio" that does not reinvest any proceeds it receives (unlike the vast majority of CLOs in the market that have such a reinvestment feature), and have a portfolio of newly underwritten loans.

How lower financing costs opens the doors to PE paying itself dividends

Most leveraged loans and high yield bonds are used by private equity firms to fund their leveraged buyouts, but private equity owners can also force portfolio firms to take out loans to fund dividend recapitalization ("dividend recap") payments that deliver profits directly to the PE firm.

Many portfolio companies were forced to take on substantially more debt within a few years of the leveraged buyout to pay dividends to the PE firms. For example, after private equity firm Sycamore Partners acquired Staples for $7 billion in September 2017, Sycamore took advantage of strong investor demand later in April 2019 to issue $5.4 billion in debt, both to refinance its existing debt and pay itself a whopping $1 billion dividend.[1]

Corporate lenders may be willing to finance this additional debt when other higher return investments are scarce, as they will be during the current crisis. CLO issuers are commonly the buyers of this new, PE-imposed debt under the belief that the PE firms are incentivized to grow the portfolio firms quickly (since CLOs receive fees based on the assets under management). The PDCF and TALF therefore lower the cost of dividend recaps since those programs lower the cost of funding for the CLOs who can better support those type of transactions.

Main Street Lending Facilities

The three Main Street Lending Facilities were designed to provide credit to small- to medium-sized companies with fewer than 15,000 employees, revenues under $5 billion, and that did not qualify for either the Paycheck Protection Program for small businesses or the Corporate Credit facilities for larger firms in the CARES Act. The eligibility criteria remain loose enough that larger firms can qualify for the Main Street programs.

[1] Ronalds-Hannon, Eliza and Davide Scigliuzzo. "Sycamore gets $1 billion in deal that amazed Street." *Bloomberg News*. April 11, 2019.

There are three Main Street credit facilities. In early April, the Fed launched the Main Street New Loan Facility (New Loan program) for companies to take out new bank as well as the Main Street Expanded Loan Facility (Expanded Loan program) for borrowers adding onto an existing bank loan. The Fed has since added a third Main Street Priority Loan Facility (Priority Loan program) that gives more leveraged companies access to loans (and updated other parts of the Main Street facilities).

The key elements of the programs include:

- Companies can take up to $200 million in loans or credit lines from participating banks under the Expanded Loan program (up from $150 million originally);
- More highly-leveraged borrowers are eligible for loans under the Priority Loan Program. The New Loan program allows companies with debt loads up to 4 times their earnings (based on earnings before interest, taxes, depreciation, and amortization, known as EBITDA), but the Priority Loan program allows companies to borrow as long as debt loads are under 6 times EBITDA (although banks are required to retain 15% of the Priority Loans compared to 5% of the New Loans); and
- Companies or lenders are allowed to custom define their own earnings (adjusted EBITDA), allowing several one-time additions to artificially inflate EBITDA. The inclusion of adjusted EBIDTA measurements allows companies to present overstated earnings figures and thus potentially qualify even with much higher debt leverage than the programs ostensibly permit.

Large private equity firms do not currently benefit as much from the Main Street programs due to the same SBA affiliation rules that deny eligibility to companies whose controlling parent company employs more than 500 people across its portfolio of subsidiaries.

The loans under Main Street also primarily refer to loans directly made between a bank and the company, which would also exclude private equity funds who operate “direct lending/private credit” funds that make a loan directly to a company without a bank intermediary. It is therefore worth watching whether the Fed will yet again change the rules to encompass more borrowers, as the Fed has stated that eligible lenders could potentially be expanded to non-bank lenders in the future.

Fed allows the same Adjusted EBITDA loophole that borrowers used to get around leveraged lending rules in 2013

The Fed’s leniency in allowing lenders under all three Main Street programs to use a custom definition of earnings is very problematic, and has echoes the “no doc” loans issued by several subprime mortgage lenders leading up to the 2008 Financial Crisis.

Unlike other figures on a financial statement, EBITDA is not a figure based on Generally Accepted Accounting Principles (GAAP) and therefore has no standard method of calculation, making it very susceptible to be artificially inflated. Under the Main Street credit facilities, higher EBITDA figures allow greater debt loads and leverage than would be permissible under more strict accounting.

Taking advantage of this, private equity firms have increasingly been using “one-time” adjustments to boost apparent earnings with items like travel expenses, legal costs, research and development (R&D), or costs savings associated with layoffs following a merger. In reality, many “one-time” charges end up becoming recurring costs, but they can serve the purpose of juicing near-term EBITDA higher than it really should be.

It is particularly striking that the Fed is allowing use of adjusted EBITDA, given that the current gaming became widespread to the point of abusive under the (now eliminated) 2013

Federal Reserve's Leveraged Lending Guidelines. Under the former guidance, regulated banks could not underwrite a loan of greater than 6 times debt-to-adjusted EBITDA. Stories quickly emerged about private equity firms creatively reverse engineering all sorts of adjustments necessary to get financing backing their leveraged buyouts below that critical 6 multiple. The Priority Loan program not only allows the same 6 times EBITDA multiple that private equity firms already abused under the 2013 leveraged loan guidelines but allows firms to provide their own adjusted-EBIDTA, making it easier for them to evade even this overly generous leverage standard.

Adjusted EBITDA Example: A private equity firm takes on a $1 billion leveraged buyout of a company that made $100 million EBITDA last year. The PE firm puts up $300 million of its own capital but secures $700 million in debt to back the purchase, so the debt leverage is 7 times EBITDA. The PE firm adjusts its EBIDTA by accounting for savings as earnings, such as finding $10 million in employee cost savings (actually layoffs) and another $10 million in other cost savings from ending on-site childcare, free coffee in the kitchen, and ending employee assisted tuition repayment. Adjusted EBITDA is now $120 million bringing debt-to-adjusted EBITDA below the critical 6 times ratio.

Same loophole allows private equity to cheat safeguards to pay itself dividends

Private equity firms have also used these very same adjustments to falsely pass key tests that lenders have historically put in place to limit how much a private equity firm can pay itself in dividends. Those tests are also premised on a debt multiple to adjusted EBITDA. In theory, if the ratio is below a certain threshold, the private equity firm can pay itself a dividend as a bonus for either growing the portfolio firm's revenue or paying down the debt faster. In practice, the private equity firm can do neither of those things, and instead just report an artificial earnings boost to bring itself below the key ratio in order to be able to pay itself a dividend. These dividends are also typically financed by additional debt, meaning the debt burden of the portfolio firm becomes even higher, making all the firm's debt more highly leveraged, riskier, and more subject to default.

Energy companies, excluded from other Fed programs, now have access to loans

It's also highly suspect that a handful of energy companies that the U.S. Treasury has expressed interest in specifically bailing out could benefit from these recent changes under the Main Street Lending Facilities.[2]

Occidental Petroleum is a prime example. The company, where former Trump special advisor Carl Icahn holds a 10% stake, was barely excluded from the Fed's Primary and Secondary Market Corporate Credit Facilities due to Moody's cutting its credit ratings to junk on March 18th and Fitch Ratings doing so on March 20th, before the March 22nd cut-off requiring an investment-grade rating to be eligible. But because Occidental has fewer than 15,000 employees and is just below the 6 times EBIDTA debt ratio at the end of 2019, it would be eligible for the Main Street programs

[2] Mohsin, Saleha, Ari Natter, and Jennifer A. Dlouhy. "Trump poised to unveil bridge loans for ailing oil companies." *Bloomberg News.* April 29, 2020.