Interview Series: What to expect from the private equity industry in the COVID-19 Crisis

Andrew Park is a Senior Policy Analyst at Americans for Financial Reform focused on issues related to private equity as well as the rest of Wall Street that intersect with workers. Previously he was a financial journalist for several publications covering private equity, corporate debt, mortgage bonds, and hedge funds.

We asked him about what he expects from the industry in the coming weeks and months as the COVID-19 crisis unfolds.

Ricardo: As someone who has covered the private equity industry as a journalist and studied it as a researcher, how would you describe the basic predatory private equity business model?

Andrew: The private equity industry has a track record of paying and taking care of themselves before they consider the needs of their portfolio companies and their employees. It shocks me how many of them have no regard for everyone else. One example is the practice of paying themselves dividends fairly early on. After they complete the buyout of a company, the company has a lot of debt. And even though that money could be used for other purposes, the private equity firm will find a reason to pay themselves out. Let's say the company spent $50 million of its own capital and borrowed the remaining $50 million. They'll find ways to get that $50 million back, if not more. This is behavior that doesn't really make sense for running a company for a long period of time. This seems more predatory than anything.

Ricardo: What are some of the insidious ways PE extracts value?

Andrew: PE firms often transfer assets away from portfolio companies. Where we've seen a number of these buyouts go wrong, especially in the retail space where many have been concentrated, you'll find that these private equity firms have used different tactics to siphon money away. And they'll do it legally because the courts have yet to rule that any of these moves are illegal.

For example, what some of these private equity firms will do is create a brand new offshore shell company that they control. Then they'll find a way to pay it dividends in the form of the company's assets. Usually in retail companies, it's very hard to move a brick and mortar store. Instead, they'll move some other kind of valuable business. It could be intellectual property as we saw with J crew, where they moved the $200 million J Crew brand into an offshore entity in the Cayman Islands. Or they could also move the most profitable online business elsewhere. In the case of Neiman Marcus, they have a business called Mytheresa, which is much more successful than their brick and mortar business. They transferred that over to an offshore entity. I think that's going to be something that we need to watch for very carefully now that we see a lot of companies running into some more difficulty. We can definitely expect to see some private equity firms looking to do some very similar maneuvers.

Ricardo: Some investors have sued over these asset transfers right?

Andrew: Yes, some investors that have made leveraged loans to PE-owned portfolio companies have challenged these offshore asset stripping tactics as illegal fraudulent transfers. What happens in these cases is that because the assets get transferred into a new shell company, the debt holders no longer have a claim on those assets. So if you transfer away $250 million, that's $250 million less in assets with the same amount of debt in the existing company. That's why you've seen a number of investors bring suits, which isn't easy. Private equity firms have very sophisticated lawyers who have designed the loan documents themselves that can include what's often referred to as a trapdoor that enables them to sort of secretly move assets away from their creditors. The first case that really prominently used this was J Crew, as I mentioned earlier, and so a lot of people refer to the ability to transfer assets like this as a J Crew trapdoor. Other times people will use the word as a verb, they'll say, we just got J Crewed. Which means assets got transferred away from you.

Ricardo: Do you have a sense of how widespread that that strategy is?

Andrew: When I asked someone in the industry how widespread this is, in the middle of last year, they estimated that up to 70% of deals have this trapdoor. They're not all uniform, so that's a very rough estimate. But the point is that a significant part of the market has this trapdoor feature. But many of the firms that buy this debt rely on the private equity industry to create investable loans for them to purchase. So, it becomes a very clubby market where they symbiotically rely on one another for their business strategy. That's why people are very wary right now because given all the trouble that companies are in, if the investments now start to really fall apart, private equity may just give up and decide to siphon assets again.

Ricardo: You've written about how the private equity industry uses leverage, or debt, as a key part of their business model. What do you think are the implications of that debt during the pandemic and the resulting economic fallout?

Andrew: People have been warning about the high amounts of debt for years now. I think over time, people have started to find reasons to say that debt is not that big of an issue. They think, "well, as long as debt can be managed we're not seeing any problems appear now." But it's not a problem until suddenly it is. I think that's what we're seeing today. Now that we're seeing a lot of highly indebted businesses all of a sudden lose a significant part of their earnings, we're finding that they can't service their debt anymore.

Ricardo: is this debt or leverage unique to private equity?

Andrew: Absolutely, because debt is the fundamental business model that private equity has been using. They will use a small amount of their own capital and then borrow the rest, but then leave it to the portfolio companies to repay it, even though the private equity firm will get the upside of the transaction.

If we think about that, at a very basic level, that's always been kind of backwards. We've seen corporations take out a historic amount of debt whether it's in their best interest or not. In many cases, we're seeing private equity firms corner certain industries. They'll take one company, and then add on other complimentary or similar businesses to either gain a significant amount of market share, or just to control many different parts of the supply chain from beginning to end of that industry, so that they can profit from all ends of it. And how are they doing that? Because of the very low interest rates.

Ricardo: Is the leverage problem bigger during the Coronavirus?

Andrew: In the past, you had certain sectors that experienced most of the hit while others were relatively okay. What's very different now is that there's no sector that's really been spared. Every single sector across the board has been absolutely hammered in the last couple of weeks. No matter what industry you pick, companies that have a lot of debt are struggling right now.

Ricardo: how does the price of debt -- how the market values loans -- reflect this rising risk of leveraged loans?

Andrew: The price of debt reflects that risk. The average price of a leveraged loan back in the beginning of the year was around 97 cents on the dollar, basically meaning the market thought the borrowers were likely to repay only 97 percent of the debt. Now we're looking at prices close to 82 cents. And that's an average. There are some sectors, like energy companies, that are trading in the 40s 50s, if not even lower. Most leveraged loans are supposed to be some of the most senior debt in the capital structure, meaning these leveraged loans are supposed to be repaid first if the company goes into bankruptcy. These leveraged loans are above high yield bonds, they're above unsecured debt, they're above second lien loans, and they're, of course, above the stock. So it should be a warning sign that some of the most senior debt is trading at levels in the 80s right now.

Ricardo: What happens to regular folks when these leveraged loans go sideways?

Andrew: When the business slows down, as we're seeing right now, private equity firms have to choose either to service their portfolio companies' debt, invest in the long-term growth of the portfolio company including its employees, or just abandon ship altogether and pay the PE firm out first. That's the kind of decision that many of these private equity owners are facing. We've seen too many instances where a number of them will just pull the ripcord and leave everyone else holding the bag. All the debt that was acquired as part of the leveraged buyout stays with the portfolio company and the company goes into this downward spiral where it's struggling to cover the debt that was inflicted upon them. And then they have to make decisions. Do they fire employees to service that debt?

That's why we're seeing a lot of Main Street anger against private equity, and it's well deserved because private equity firms are the only ones benefiting from that debt. If the portfolio company is not growing because of this additional debt, then it's just becoming a drain on the company. But again, this comes back to this bigger issue. Why is it that private equity is still turning a profit even when companies liquidate as we saw at Toys R Us, where tens of thousands of people lost their jobs?