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

Eileen Appelbaum is Co-director of the Center for Economic Policy Research and a distinguished researcher and author. Appelbaum is a longtime observer of the private equity industry and its impacts on the economy and co-author of the acclaimed 2014 book, Private Equity at Work, When Wall Street Manages Main Street.

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

Ricardo: The PE industry went on a buying binge after the Great Recession, should we expect the same leveraged buyout and mega-merger wave by private equity?

Eileen: I don't think we're going to see a whole lot of these really big mergers and acquisitions, developing new platform companies that are going to go into other industries and cannibalize them by buying up all the smaller competitors. That is fairly risky. Where there have been some deals like that, they were in the works before the pandemic. If they still look good after the pandemic, they will happen. There will be some of these large mergers, but what we're mostly going to see is much smaller.

Ricardo: Does that mean the PE buying binge is over?

Eileen: No, I think we'll see a lot more private equity firms investing in companies where they don't take control. That's another way of making money. Just like everybody else, they can invest in publicly traded companies, and can get in and out whenever they want. So that's attractive. Investing in venture capital startups, where they don't take control but where they say "this is a startup, and it's going to have a good future once things get more or less back to normal" and take a minority position. I think it's already happening. We've seen private equity companies step in and take minority positions in Airbnb, now that Airbnb's valuation has been slashed compared to where it was in January. I'm also thinking about other kinds of companies that may have a lot of debt, perhaps due to the requirement of modern, sophisticated, up to date equipment. Those kinds of small businesses will be ripe for the pickings by private equity when this is over. They will really be struggling, and we aren't doing enough to protect them.

The big thing we are going to see is further kinds of acquisitions that are basically add ons to existing platforms. Small business loans are not going to businesses that have a lot of debt because they rely on expensive capital and technology. A lot of doctors' practices are not currently owned by private equity. But those doctors' practices are having a hard time, even if they got the small business loan that would allow them to make payroll. It would allow them to pay rent, it would allow them to pay utilities, and if there was anything left, they could pay interest on some of their debt. But that debt is going to continue to pile up. And some of these practices that have resisted becoming a part of a private equity company may feel that they have no choice. They're going to have to sell out to private equity to maintain their business.

Ricardo: Health care will become a bigger piece then, can you describe some of the strategies?

Eileen: The other thing that I'm anticipating is that private equity will move upstream and downstream from its current investments. Let's suppose a PE firm has a large investment in medical suppliers. It will move upstream to say "okay, we are supplying these products to urgent care centers, doctors practices, and hospitals. Could we manufacture them, could we produce them? They will go upstream to acquire producers of the products that they would most like to be able to distribute at an advantage because if they're manufacturing, they will be manufacturing for many medical suppliers not just for their own. And of course, they will always have the advantage compared to the other companies that have been supplied.

Then they will move downstream as well. Urgent care is a highly fragmented part of the healthcare system in America. And it has been ripe for anybody who wanted to consolidate it. This consolidation has already started, but it has not progressed very far. This will be an opportunity for private equity owned medical supplier companies that want to move into urgent care to be able to own the downstream part of the supply chain. So I think we're going to see a lot of consolidation along supply chains in industries where private equity already knows the industry and where the acquisitions are relatively small compared to taking a publicly traded company private. So I think that those are the things that I'm anticipating that we will see.

RICARDO: Private equity has already done a lot of these health care roll-ups, will they keep buying more?

Eileen: In the short term one challenge for the industry is related to how they like to buy companies. They like to use only a little bit of equity and a lot of debt. But the private debt markets are frozen at this time. Nobody knows who has made those loans, which of them are actually going to be repaid, and which are going to default. For example, KKR's Envision owns doctors practices and had no trouble raising an enormous amount of debt when it expanded. But It's having trouble making those payments on surgical centers that are part of its portfolio [because elective surgery procedures have been suspended during the pandemic]. So their income is down and they tried to do a "distressed exchange" [to get lenders to trade their poorly performing debt for equity in Envision]. Not knowing whether even KKR's Envision will be able to repay its debts in a timely fashion has really put a crimp into the private debt markets.

Ricardo: Do these locked up debt markets prevent a private equity buying spree?

Eileen: At this time it's not really that easy for them to go out and say, "Oh my God, there are all these distressed assets! Let's go buy them up now." That piece of it is pretty much on hold. We'll see some buying, but that's mostly going to come later. Some of what you do see right now is what are called PIPE's, private investments in public enterprises. They are identifying companies with really cheap stock prices who they think will recover nicely after the pandemic is mostly over. They're buying that kind of stock. But they aren't going out and wholesale buying big companies, that's just not happening at the moment.

Ricardo: What's happening with the portfolio companies they already have?

Eileen: Having watched this industry for a while, I think that they're looking at their portfolio companies and figuring out which ones they want to save and which they would be happy to take through a bankruptcy and get what they can out of them. Perhaps they've already sold off the real estate. Perhaps they've already taken monitoring fees and they may already have paid themselves back.

I'm thinking about retail in particular at the moment. The retail apocalypse really did not end, the booming economy really just slowed things down. We've had many retail companies go under even during this recent boom period. So if you have a retail company as part of your portfolio, you might say to yourself, "There's no future for brick and mortar. I've already gotten my money back out of it, I even might have made a profit. I don't think this is a company where I want to commit to anything for keeping the workers on the payroll and keeping the stores open. I'll be glad to be able to blame the bankruptcy on the pandemic and escape with my reputation intact as far the limited partners are concerned and move on."

Ricardo: What about restaurants, is that a similar story for the 40,000 plus PE-owned restaurant locations?

Eileen: Yes, we see it already with restaurants, where the private equity industry did get an exemption [in the CARES Act] for themselves, along with other restaurant chains not owned by private equity. Publicly-traded restaurant chains are able to get small business administration loans by way of commercial banks under the CARES Act. Those restaurant chains are able to qualify even though they have 500 or more employees. Private equity funds that own restaurants have gotten the same waiver. Even if they can qualify for those loans, however, you see many private equity owned restaurants remaining closed. It's not clear that they are even applying for those loans. They will probably try to save their up and coming restaurants. The same is not true for the ones that are just limping along; they're not the kind of restaurants people go to anymore, or they're located in neighborhoods that are no longer prosperous, whatever the reasons are.

Ricardo: What about other Coronavirus corporate bailouts, is PE trying to take advantage of those resources too?

Eileen: There's another set of issues for private equity in the current period where the bigger [Coronavirus bailout] loans are going to be made available to companies with up to 10,000 employees. There's no restriction on private equity companies applying for those funds. The restrictions on the small business loans come from rules that the SBA has had in place for a long time, except for the restaurants that got a special exemption. There's no restriction on the half a trillion dollars that's going to companies and that then can be levered up with funds from the Federal Reserve. The issue there is that the Fed generally does not make loans for speculative grade companies' debt which, of course, is what most private equity has. But the Fed has relaxed the standards on that. So these PE owned companies are going to be able to get their hands on some of that money.

Ricardo: And there are no conditions on any of these taxpayer bailouts, to keep workers, provide workplace protections from Coronavirus, offer decent wages, anything. How will these PE firms use this unconditional taxpayer subsidy as the economy begins to recover?

Eileen: I think they are poised, once this pandemic is over, if there are no conditions, to just buy huge parts of the economy. Certainly in health care. And is that really where we want them? We already have a situation in which Team Health fired an emergency room doctor with 17 years of experience because he spoke out about the poor safety conditions in the hospital and the lack of protective gear for the health care workers. This is just outrageous. We see private equity in doctors practices, slashing the wages and benefits of frontline doctors who are working and laying off the ones that are not working. I bet those doctors never imagined that that could happen. If you're a doctor in a surgery center or someplace. They're just laying you off. Even the ones working really really hard right now to save people are facing cuts in pay and benefits at a time when they need support. We already see how they treat their workers.

Ricardo: Right, and what about the patients — during Coronavirus and afterwards?

Eileen: We also know about the surprise medical bills. There's no concern for patients either. It's not like private equity has gone into health care because it has a mission of saving lives. It's gone into health care because it sees an opportunity to make outsized profit. We have to think about whether we want them taking over even more of our healthcare system than they already own. And the same is going to be true for many industries where they will be in a position to look up and down the supply chain. I mean, do we really want them to be able to do this with no oversight and with no requirement that the public has any idea of what they're doing? And with all of the possibilities for carrying out financial engineering, as they have been wanting to do all time?

Ricardo: Are there no positive stories about private equity? Is it all bad, mostly bad, or a mixed bag?

Eileen: When Rose [Rosemary Batt] and I wrote the book [Private Equity at Work: When Wall Street Manages Main Street] we found that there are a lot of really excellent private equity firms out there. These are small PE firms, they buy smallish companies, and they actually do what private equity says it does. And that is, they invest in the operations of these companies. They improve their technology. They put people on their boards who understand distribution. They help them get access to financial resources. And it's really a win win. Those companies tend to be small, the funds tend to own only a few of them, and they may be eligible for the small business bailout fund in the CARES Act.

It's the big PE firms that we hear about, that make major acquisitions of big companies, or that buy up lots of little companies and use them as add ons to a platform to build bargaining power over prices and wages. That's where the problems are. And that's where we need to have these constraints on M&A during the pandemic and on financial engineering now and in the post-pandemic period. Otherwise, you won't recognize the economy when the pandemic ends. It will be shareholder value on steroids. Everything will be done with an eye to making profit for the limited number of people who benefit from these private equity owned enterprises--mainly the private equity firm and its partners. They of course, are part of the 1%. So we really need to have some better regulation of them.