Response to "Private Equity and the Resolution of Financial Distress"

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This paper is quite useful in establishing facts about the economic impact of private equity. It is a topic on which there is a lot of misinformation and disinformation to cut through. Leaders of organized labor have tended to view leveraged buyouts as a threat to job security. Being savvy in the public relations realm, they have not made their case in terms of their members' self-interest but rather on the basis of the harm that LBOs allegedly inflict on the economy at large. The private equity firms have responded in kind in the public debate, where they have understandably not dwelled on the prospect of outsized profits that they dangle before their limited partners.

I am all in favor of the profit motive and streamlining corporations in pursuit of superior returns on capital. Those are not good enough reasons, however, to presume that the private equity firms have the better of the argument regarding the economic impact of their activities. As the authors of this paper point out, recent research by Guo, Hotchkiss, and Song concludes that the gains on going-private transactions owe as much to tax benefits from increased leverage and general increases in equity valuations as they do to operating gains. The tax savings and rise in stock market valuations do not represent contributions to national wealth and it is not even self-evident that the operating gains represent efficiencies that benefit the economy at large. Perhaps, instead of inducing management to cut waste and work harder, the private equity firms buy companies at low points in their profit cycles and ride them back up.

If this sounds overly cynical, I invite you to study the Hospital Corporation of America buyout of 2006. The website of one of the private equity acquiring firms emphasized the way its investment bankers worked with management to improve operations, but I heard no mention of such planned reforms when the deal was announced. Rather, the talk was all about the great job that the incumbent management was doing and how the acquirers expected them to continue. This was so counter to the private equity industry's story of the benefits it was conferring on society that in order to raise financing, the bond salesmen felt obliged to speculate that the company secretly planned to make significant asset sales after the deal was completed. Skeptics could be excused for suspecting that the true agenda was to buy HCA at a low point in its market valuation, using leverage, and ride the stock back up. The question was why institutional investors did not prefer to buy HCA stock on margin, without paying a substantial control premium, without giving away 20% of the gains, and without paying 1.5% to 2% a year in management fees for the privilege.

The point is that both the critics and the promoters of leveraged buyouts have strong incentives to foster impressions that may not accord with the facts. Hotchkiss, Smith, and Strömberg have collected objective data with great effort, for which they should be commended. Their particular contribution is to compare outcomes for PE-backed firms with outcomes for other speculative grade borrowers. Let me comment on a few findings that I find especially interesting.

First, PE-backed firms are more likely than their non-PE peers to engage in pre-negotiated bankruptcies. Combined with the finding that the PE firms emerge from Chapter 11 more swiftly, this does imply a positive impact on the economy, through eliminating the deadweight costs of bankruptcy resolution. I suspect the private equity owners tend to be more dispassionate and levelheaded when dealing with financial distress than managers who are more emotionally invested in their companies.

It is also noteworthy that PE firms are active in buying companies out of bankruptcy, with infusion of new equity playing a prominent role. The paper does not address the subsequent performance of the rescued companies, but it may very well be that private equity firms are preserving economic value that might otherwise get lost through liquidation. The other most likely buyers are typically conventional, public corporations, which might be averse to earnings dilution in the first few years after buying a company in need of extensive repairs. Better for those public acquirers to make acquisitions of healthy companies that will be accretive almost immediately as a consequence of synergies—or so it is frequently claimed.

For high yield bond and leveraged loan investors, it is useful to know that leveraged buyout issuers default at a higher rate than non-LBOs. Finally, it is useful to learn that only a small percentage of defaulted firms either added to their indebtedness to pay dividends or bought back stock.

All in all, “Private Equity and the Resolution of Financial Distress” constitutes a valuable expansion of our knowledge of an economically important phenomenon about which a great deal of confusion has been intentionally sown over the years.