Brexit, Private Equity and Management

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Abstract

We analyse the expected impact of Brexit on private equity and its implications for management research. Specifically, we explore the implications for PE funds and funding, and at the portfolio firm level with respect to employment and performance.

Introduction

We explore private equity (PE) as the risk capital used to finance the acquisition of mature businesses via a Leveraged Buyout (LBO). A portfolio firm acquired through an LBO combines equity capital from the PE fund with debt finance secured against the portfolio firms' assets and/or future cash flows (Gilligan & Wright, 2014). An LBO leads to changes in ownership and governance of portfolio firms. Management teams typically receive a significant equity share, aligning managers with PE firm objectives. In larger deals, PE firms usually take the majority equity stake and board representation to actively monitor performance and provide strategic advice to guide firms to the realisation of capital gains. PE firms specify contractual conditions regarding both management behaviour and information provision regarding the portfolio business.

LBOs account for three quarters of total UK merger and acquisition activity by transaction numbers and the UK has the largest PE market in Europe (CMBOR, 2016). After emerging in the mid-1980s the PE market reached its peak in 2007. In the wake of the financial crisis LBO activity declined. Prior to Brexit, the market had recovered to levels comparable to the late 1990s and early 2000s. However, in the first half of 2016, deal values declined sharply with the largest deals being adversely affected by macroeconomic uncertainties, including Brexit (CMBOR, 2016). Pre-referendum there was a strongly expressed view that remaining in the EU would be most favourable to portfolio companies (BVCA, 2016).

Before 2007 the PE industry operated largely below the radar of public attention, but immediately prior to the banking crisis the industry became subject to scrutiny by governments and parliaments on both sides of the Atlantic. Critics made claims of short termism, cost cutting, asset stripping, excessive leverage making portfolio companies vulnerable to failure, and deleterious effects on innovation, employment and employee relations (ITUC, 2007). Subsequent debate resulted in enhanced regulation and disclosure (Buckley and Howarth, 2011).[1] This EU level regulation leads to a need to understand the potential impact of Brexit on PE. Indeed, for management researchers, Brexit provides a natural experiment to explore the effects on PE of a major exogenous shock. We explore Brexit's implications for both PE funds and portfolio firms.

PE funds and funding

In this section we examine the implications of Brexit for PE funds and other forms of funding for PE, notably governmental schemes.

PE funds

Brexit will have an indirect effect on UK PE fund raising due to market uncertainty, which damages confidence. As each fund has a limited life, PE has a requirement to continuously raise new funds. Fund returns have been counter-cyclical and the asset class shows good returns compared to other investments (Harris et al., 2012). Brexit, however, is an extraordinary shock and there will be a need for research to explore the effects on fund returns. Some PE firms may seek to locate offices within the EU, potentially leading to job losses in the sector. This raises potentially interesting research questions regarding the locational responses of multinational financial service firms to an exogenous shock.

Unlike other funds, PE funds are long term commitments for investors, so capital already committed to a fund cannot be cancelled or withdrawn. Fund investors may choose to try to liquidate their commitments using the secondaries market, an emerging market feature that has

[1] Gilligan was on the Institute of Chartered Accountants in England and Wales committee that reviewed the first draft of AIFMD and joined with others to successfully lobby to have it redrafted.

received scant research attention. Funds' long term investment horizon gives PE firms greater insulation from short-term market sentiments. Whereas some other types of UK funds have already had to stop withdrawals, this "run" cannot happen to a PE fund. This means there can be no external imperative for a fast exit from portfolio firm investments. More likely, if an economic downturn is triggered, is that there will be a further increase in the holding period of investments. These have been increasing since the financial crisis due to adverse conditions for corporate acquisitions as an exit route from portfolio firm ownership. This lengthening of holding period will reduce returns as measured by IRRs.

There might be concern for new funds, however. In addition to increased uncertainty, many UK based funds raised post-Brexit have been raised in the EU and denominated in Euros. UK fund managers are reported to be expecting a tougher time (Financial Times, 2016). Furthermore, it is widely reported that several proposed LBOs have been aborted as pre-completion conditions on Brexit in debt finance documentation have been triggered, leading to that source of finance being withdrawn.

A further question concerns the availability of debt on which PE funders rely. UK banks have already largely pulled out of bigger deals and US debt funds have entered the market. If debt funds exit the market in the light of Brexit, prices will fall and PE will be liquidity constrained like early 1990s. One solution could be for government to stimulate a debt market.

PE has no specific regulations that pertain to it alone. After the financial crisis, the EU developed the AIFM Directive (AIFMD). It has two key impacts on PE firms: marketing by AIFMs is regulated to protect investors and fund flows are managed to limit the possibility of fraud. As noted above, the UK is dominant in PE provision in Europe and the original draft legislation was substantially rewritten under influence from the UK. The next revision is due for negotiation and if the UK is not involved, the EU may impose regulation that will inhibit the ability of UK PE firms to access the EU institutional and retail investment markets. As a significant proportion of funds are from EU investors (Gilligan & Wright 2014), UK firms may find the loss of regulatory influence will threaten funds .

In sum, there are important research avenues regarding future financing structures of portfolio firms and its impact on those firms and managing value creation when PE-backed ownership occurs over a longer period.

Policy schemes

The Enterprise Investment Scheme (EIS) provides incentives to invest in early stage and growing ventures in the UK. These tax incentives have been advantageous for retail PE investors. The operation of Venture Capital Trusts (VCTs) has been subject to EU scrutiny in respect of ‘state aid’ for industry regulations. The amendments contained in the 2015 Finance Bill essentially ruled out the funding of buyouts using these schemes to comply with EU state aid rules. Post-Brexit there may be opportunities for government to re-introduce more flexibility concerning state aid to stimulate PE investment in growth finance and the buyout sector. There are thus opportunities for policy researchers in management to explore both regional policy effects and more general impacts on entrepreneurial businesses of changes in the incentive regime following Brexit. However, the extent to which this may be feasible will depend on the relationship with the Single Market that is negotiated.

PE portfolio firms

In this section we examine the impact of Brexit at the portfolio firm level, specifically in terms of employment and performance.

Employment

Potential restrictions on the freedom of movement following Brexit have implications for recruitment. UK firms will find it more difficult to recruit low- and high-skilled workers, potentially leading to wage inflation. Consequently, portfolio firms seeking to make efficiency improvements might find them more difficult to achieve. If a points based system of immigration is extended to EU citizens, top talent might still be recruited to portfolio firms and PE firms; however, if it operates too tightly, it could have a negative impact on human capital within firms, lowering productivity.

Brexit removes a liberal market voice in Europe and so future EU labour legislation will likely reflect the political preferences of Europe's coordinated market economies. This will lead to more onerous directives on employment, applying to UK PEs' portfolio firms operating in the EU. Therefore, there is the potential for the UK and EU to subject firms to different labour market regulations. This would make post-LBO efficiency gains more difficult to achieve in EU located portfolio firms but easier to achieve in UK located portfolio firms.

Although several areas of employment legislation most relevant to portfolio firms pre-date the UK's EU membership, British businesses may seek changes to EU directives including the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE), the EU Collective Redundancies Directive, Agency Worker Regulations 2010 and decisions of the Court of Justice of the European Union (CJEU) on annual leave. Additionally, the Beecroft Report (2011), which proposed making redundancy easier, would now be easier to implement. Reductions in regulation might create a deregulation premium, making it easier for portfolio firms to cut costs. Research could examine the extent to which UK employees' inferior terms and conditions contribute to portfolio firms' performance gains and investor returns. Note, however, maintaining access to the European Economic Area (EEA) will require the UK to maintain EU labour laws.

The macroeconomic environment is likely to impact employment in portfolio firms as a consequence of the different strategies employed e.g. efficiency versus growth (Bacon et al., 2013). Growth buyouts would look to exploit entrepreneurial opportunities and increase employment (Boucly et al., 2011; Meuleman et al., 2009), but with economic uncertainty and a downturn we will likely observe fewer deals of this type. Efficiency buyouts reduce costs and are more likely to result in job losses; however, they do seek to create sustainable businesses, which might preserve jobs that would otherwise be lost. Future research could therefore explore the potential shift in the relative importance of efficiency and growth buyouts.

Performance

PE portfolio firms have shown survival and performance resilience during the financial crisis and recession in terms of productivity, profitability and growth (Wilson et al., 2012); financial distress (Wilson and Wright, 2013) and exporting propensity and intensity (Wilson and Wright, 2016a). This performance, observed during the recent downturn and recovery, may make these firms attractive investments in turbulent periods. Future research could examine the different roles of efficiency versus growth motivated LBOs in delivering performance gains.

Despite the impact of regulatory disruption discussed above there could be opportunities for PE to exploit new opportunities post Brexit. From a company perspective, prime determinants of export performance concern relative efficiency and having diverse and experienced boards with international networks (Wilson and Wright, 2016a). PE backed firms show a greater propensity to seek and deliver export sales through these routes. Reconfiguring of global trading relationships could provide access to new export market opportunities aided by favourable movements in relative export prices. However, given the uncertainty regarding the terms of trade with the EU and elsewhere, the risk of shocks to export led business models in the UK have increased. Banks lending to PE deals may also be more cautious in funding these deals. Therefore, we might expect a change in the type of firms PE funds support away from exporters and towards domestic focussed businesses. If the UK wished to reduce its balance of payments current account deficit, this will be unhelpful. Future research needs to explore to what extent there is a shift in both the level of exporting and export markets targeted following Brexit.

If forecast dampening of growth and asset prices occurs, consequent increases in the incidence of corporate distress could provide attractive targets for PE investors. Alternatively, if asset prices are reduced, corporations and family owners of private businesses may be reluctant to sell unless they are under pressure to do so (Ahlers, et al., 2016). Foreign divestments typically represent around 6% of PE buyouts, but could rise in importance in the short term. If foreign parent companies have been using the UK as a gateway to the single European market, they might decide to divest UK subsidiaries. Managing the process of corporate divestment is an area meriting further investigation.

PE target companies have the potential for strong growth investment opportunities in the regions (Wilson and Wright, 2016b). Brexit has focussed attention on regional and sector imbalances in the UK economy. Government policy to tackle these issues could draw on PE experience to play a significant role in this restructuring, taking advantage of the potential removal of EU ‘state aid’ rules in tailoring incentives for investors to support specific sectors, regions and export markets. If the government decided to provide support to specific PE activities, future empirical analysis of its impact and effectiveness would be required.

Conclusions

Brexit creates threats and opportunities for both PE firms and their portfolio companies. Within the UK context, PE funds are more resilient than other fund types; however, UK PE firms' access to the EU to conduct deals and difficulties in raising funds will be problematic, threatening the UKs position as the leading European nation in PE. The activities of PE firms within the UK might be subject to less regulation, potentially creating a deregulation premium. In addition, the EU may no longer impede state aid if the UK government decides to use it. The forecast economic downturn creates a challenging environment; however, UK PE funds have been more resilient than other types of UK funds and portfolio firms have shown performance resilience. These developments will have short and long term consequences. For management researchers focused on entrepreneurial finance they present an exciting new research agenda.

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