PRIVATE EQUITY STAKEHOLDER PROJECT
PEstakeholder.org

February 9, 2023

Private Equity, Bankruptcy, and Layoffs

1. Introduction

Historical data showing employee layoffs at private equity owned portfolio companies suggests that there is likely a close nexus between (1) highly leveraged portfolio companies, (2) the private equity business model that relies on such leverage, (3) bankruptcies at private equity-owned companies, and (4) job layoffs.

This brief seeks to demonstrate that private equity investments increase the likelihood of bankruptcy and job layoffs.

Private equity firms tend to use high leverage when acquiring companies. During times of economic stress such as the 2008 financial crisis or the initial Covid-19 economic shock or in sectors experiencing distress, such companies are more likely to default on debt, go bankrupt, and lay off employees than similarly situated companies that are not similarly leveraged.

This brief will use three studies and one article to explain the phenomena of the corporate debt-layoff nexus, and why such debt strategies must be addressed and/or accounted for to curb current, anticipated, and unexpected unemployment levels.

2. Studies

a. California State Polytechnic University

A 2019 study by Profs. Brian Ayash and Mahdi Rastad highlights the connection between leveraged buyouts and higher incidents of bankruptcies at the acquired companies.[1] From a private equity perspective, this is important because acquiring companies through leveraged buyouts is a tried-and-true private equity investment strategy.[2]

Tracking a sample of 484 public to private leveraged buyouts for 10 years after going private, the authors found a bankruptcy rate of approximately 20%, which was greater than the 2% bankruptcy rate for the control sample (i.e. non-leveraged buyout firms).[3]

The authors went to conclude that, **"[g]iven the large number of recent high profile private equity backed LBO bankruptcies, it is difficult for policy makers to ignore the impact of these controversial transactions on their constituents and society as a whole. Moreover, given the economic significance of the typical LBO target firm, its bankruptcy not only affects the welfare of its shareholders and lenders, but it also directly impacts the lives of tens of thousands of employees. Finally, while suppliers, customers, local economies, pension funds, state and federal government tax revenues all feel the burden when an LBO company goes under, the partners at the private equity funds do not share the burden."[4]**

b. National Bureau of Economic Research (NBER)

A 2019 NBER study argues that **"[a]n employee's annual earnings fall by 10% the year her firm files for bankruptcy and fall by a cumulative present value of 67% over seven years. This effect is more pronounced in thin labor markets and among small firms that are ultimately liquidated."[5]**

This study is unique because it directly addresses the impact of bankruptcy at highly leveraged companies on their employees rather than just job loss. This includes employees that remain with the company but that also experience a decrease in wages as a result of the bankruptcy.[6]

Interestingly, in a later analysis of the paper that same year, an NBER article calls for increasing wages for employees at highly leveraged companies as a means to account for the bankruptcy/wage decrease risk. Although not exactly on point for our purposes, one could argue that requiring highly leveraged firms to pay more into unemployment insurance addresses the same issue.

c. Center for Economic Studies (CES)

A 2017 CES study by Profs. Xavier Giroud (MIT) and Holger M. Mueller (NYU) found that, **"when faced with a drop in consumer demand, more highly levered firms are less apt (or able) to raise additional short- and long-term debt during the Great Recession. As a consequence, they experience more layoffs, are more likely to close down establishments, and cut back more on investment. Altogether, our results suggest that firms with higher leverage not only appear to be**

more financially constrained, but they also act like financially constrained firms in the Great Recession."[7]
Focusing on the Great Recession, the authors argue that firms' balance sheets were instrumental in propagating consumer demand shocks, meaning that companies owned by highly leveraged firms were more likely to lay off employees in response to drops in consumer demand. Other factors like declines in productivity, overextension prior to the Great Recession, or generally more sensitive to fluctuations in either aggregate employment or house prices did not drive this phenomenon, according to the authors.[8]

At the county level, they found that "**counties with more highly levered firms experience significantly larger job losses in response to county-wide consumer demand shocks."** Thus, they conclude that firms' balance sheets also matter for aggregate employment.[9]

d. Do Buyouts (Still) Create Value? **(2011)**

The authors, Shourun Guo, Edith Hotchkiss, and Weihong Song examined how leveraged buyouts from the 1990-2006 wave of public to private transactions created value.

Of the LBOs reviewed in the study, 20% subsequently resulted in bankruptcy.[10]

e. The evolution of capital structure and operating performance after leveraged buyouts: Evidence from U.S. corporate tax returns **(2014)**

The authors, Jonathan B. Cohn, Lillian Mills and Erin M. Towery used corporate tax return data to examine the evolution of firms' financial structure and performance after leveraged buyouts (LBOs) for a comprehensive sample of 317 LBOs taking place between 1995 and 2007.

The study found that firms do not reduce leverage after LBOs, even if they generate excess cash flow.

The study documented that of the 353 LBOs studied only 224 had exited private equity control, and of these 49 firms (22%) had bankruptcy exits.[11]

f. The new demography of private equity **(2008)**

The author, Per Strömberg, found that highly leveraged private equity-owned firms experienced higher bankruptcy rates than comparable publicly-traded firms. **Strömberg found that for the LBOs that occurred between 1970 and 2002, the rate of bankruptcy or reorganization was twice as high as it was for publicly-traded companies.**

For LBOs completed by 2002, a total of 7 percent of the deals ended in bankruptcy or reorganization while the acquired company was in PE hands. Assuming that firms are held on average for 6 years, Strömberg calculates that this works out to an annual default rate of 1.2 percent a year. He notes as a comparison that the annual default rate for publicly-traded companies over this period was 0.6 percent.[12]

3. "Private Equity-Owned Companies Fuel Surge in Defaults," Institutional Investor, Jul 17, 2020.

"*More than half of companies that defaulted in the second quarter* [of 2020] *are owned by private equity firms, Moody's said in a report . . .*"

4. "Private Equity Has a Retail Problem," American Bankruptcy Institute Journal, January 2018.

"*The authors queried The Deal Pipeline and identified 481 large chapter 11 filings (liabilities in excess of $100 million at filing) from mid-2011 through mid-2017. Here are the findings:*

• Approximately 25 percent of these 481 filings over this six-year period were PE-owned companies, but that percentage moved appreciably higher in 2016 and 2017 (as shown in the exhibit), with 40 percent of chapter 11 filers in 2017 (through September) being PE-owned companies (26 of 65).

• Overall, 55 percent (24 of 44) of chapter 11 filings by retailers since 2011 occurred in 2016 or 2017, but for PE-owned retailers, 80 percent (16 of 20) of such filings occurred in 2016 or 2017.

• Two-thirds (16 of 24) of chapter 11 filings by retailers in 2016 and 2017 were sponsor-owned/controlled companies. Six of these 16 PE-owned retail filings in 2016-17 were buyouts done in 2005-08, two were done in 2010, and eight were done in 2012-15. On average, these chapter 11 filings occurred 6.3 years after a buyout was consummated, with a median time of 5.5 years.

• The retail sector accounted for a disproportionate share of LBO busts. LBOs of retailers accounted for 9 percent of all large LBO transactions (>$50 million) completed in the last decade, yet accounted for 17 percent of chapter 11 filings by PE-owned companies in the most recent six-year period. In short, private equity appears to have a retail problem."

5. **Forbes Article**

A 2019 Forbes article examined the relationship between private equity firms and job loss. With respect to the debt-layoff nexus, the author warns that **"[t]he companies to look at for potential future layoffs are those private-equity backed companies, which have recently defaulted on their debt payments, and those with distressed credit ratings. [In 2019] 14 private equity backed rated companies defaulted. The highest number are in the retail sector."**[13]

Explaining the how the nexus operates, she goes on to state:

"[Private equity] backed distressed rating companies, those that are rated B- or worse and which also have a negative outlook, have risen by almost 30% since last year. Consumer products and industrials are the majority of [private equity] backed companies that have distressed credit ratings. These distressed rating companies are the ones to watch for potential cost cutting to service the debt, that is, people are at risk of losing their jobs. To avoid defaulting, these distressed rated private-equity backed companies are likely to be pressured to lay off employees in order to service their debt.[14]

6. **Counterarguments**

   a. Do private equity owners increase risk of financial distress and bankruptcy? **(2011)**

   "*Our paper suggests that private equity investors select companies which are less financially distressed than comparable companies and that the distress risk increases after the buyout. Despite this increase, private equity-backed companies do not suffer from higher bankruptcy rates than non-buyout companies. In fact, when companies are backed by experienced private equity funds, their bankruptcy rates are even lower.*"

   b. Private Equity and the Resolution of Financial Distress **(2020)**

   "*When firms do default, PE-backed firms restructure more often out of court, restructure faster, and are more likely to remain an independent going* *concern following the restructuring. PE owners are also more likely to retain control of the firm following the restructuring. The propensity for PE owners to infuse capital as firms approach distress is positively related to measures of the success of the restructuring. Overall, our results show that PE sponsors resolve distress in portfolio firms relatively efficiently*."

7. Conclusion

The private equity business model relies on high leverage to acquire companies and extract revenue from them. This business model is risky from a labor-employment standpoint because studies show that there is likely a nexus between highly leveraged companies, bankruptcies, and layoffs. As national and state economies continue to recover from the economic shocks of the COVID-19 pandemic, policymakers should take steps to protect the job security of their constituents by preempting the proliferation of the debt-layoff nexus in their jurisdictions and ensure that private equity firms and private equity owned companies are appropriately paying into unemployment insurance funds relative to the risk they create. This could look like requiring highly leveraged private equity-owned companies to pay more in unemployment insurance based on credit risk, thereby increasing the safety net for at risk employees.

---

[1] *Leveraged Buyouts and Financial Distress,* Brian Ayash and Mahdi Rastad, July 19, 2019.
[2] https://online.hbs.edu/blog/post/types-of-private-equity
[3] *Leveraged Buyouts and Financial Distress,* Brian Ayash and Mahdi Rastad, July 19, 2019, pg. 1.
[4] *Leveraged Buyouts and Financial Distress,* Brian Ayash and Mahdi Rastad, July 19, 2019, pg. 14.
[5] https://www.nber.org/system/files/working_papers/w25922/w25922.pdf, pg. ii.
[6] https://www.nber.org/system/files/working_papers/w25922/w25922.pdf, pg. 3.
[7] https://www2.census.gov/ces/wp/2017/CES-WP-17-01.pdf, pg. 4.
[8] https://www2.census.gov/ces/wp/2017/CES-WP-17-01.pdf, pg. ii.
[9] https://www2.census.gov/ces/wp/2017/CES-WP-17-01.pdf, pg. ii.
[10] *Guo, S., E. S. Hotchkiss, and W. Song (2011). Do Buyouts (Still) Create Value? The Journal of Finance 66 (2), 479–517.*
[11] *Cohn, J. B., L. F. Mills, and E. M. Towery (2014). The evolution of capital structure and operating performance after leveraged buyouts: Evidence from U.S. corporate tax returns. Journal of Financial Economics 111 (2), 469–494.*
[12] Strömberg, P. 2008. "The New Demography of Private, Equity." The Globalization of Alternative Investments Working Papers Volume 1: The Global Economic Impact of Private Equity Report 2008, World Economic Forum, January: 3-26.
[13] https://www.forbes.com/sites/mayrarodriguezvalladares/2019/10/30/private-equity-firms-have-caused-painful-job-losses-and-more-are-coming/?sh=5c93e4727bff
[14] https://www.forbes.com/sites/mayrarodriguezvalladares/2019/10/30/private-equity-firms-have-caused-painful-job-losses-and-more-are-coming/?sh=5c93e4727bff