FT Alphaville Private credit

The dodgy details of private equity's 'dividend recaps'

The impact of leveraged payouts examined

Robin Wigglesworth 5 HOURS AGO

Earlier this summer, the private equity firm 3i paid itself over €1bn with money one of its companies had borrowed, helping bring the volume of these so-called "dividend recapitalisations" to a new record.

On one hand, this demonstrates how much value private equity firms can create for their investors. 3i paid just €130mn for a controlling stake in the Dutch retailer Action back in 2011, and since then it has extracted about €4.5bn from the company through eight dividend recaps.

The company has been able to keep borrowing to chuck money back to its owners thanks to a huge increase in its earnings over the past decade (Bryce wrote a great post on how big a deal Action is for 3i here). Here at FT Alphaville we've been somewhat sceptical of the private equity investment case, but this is a clear winner.

On the other hand, companies borrowing more and more money purely to pass it on to private equity owners isn't really a good look, and can cause problems further down the line.

This is particularly pertinent given that MainFT is reporting that private equity firms are pushing for changes to loan docs that would allow them to pay themselves even bigger dividends. (remember when private equity barons insisted back in 2023 that they would "go back to investing in the old-fashioned way" and rely more on operational nous than leverage? Good times).

All this is why FT Alphaville was so intrigued to spot this paper by Abhishek Bhardwaj, Abhinav Gupta and Sabrina Howell in our weekly round-up of research published by NBER, which put some number on the general vibes around dividend recaps.

It argues that the strategy:

> . . . lead to misaligned incentives and moral hazard problems for GPs, causing them to pursue activities that diverge from the interests of fund investors, company employees, and pre-existing creditors.

Here's how the study worked: Across the sample of about 47,000 US leveraged buyouts by 1,200 private equity firms between 1995 and 2020, the researchers found almost 1,600 dividend recaps. They then paired this with data on loans, fund returns, payrolls and bankruptcies.

Bhardwaj, Gupta and Howell found that dividend recaps mostly happen at larger, healthier companies. This makes sense, as it's a lot easier to get creditors to feel comfortable with this kind of financial milking when they can see solid cash flows coming in.

Once you adjust for that, dividend recaps massively increase the danger of bankruptcies:

> . . . The causal analysis paints a picture in which new debt induced by cheap credit increases firm risk, consistent with theories predicting agency problems of debt. We focus first on the firm. We show that dividend recaps increase the chance of bankruptcy, for example by 31pp in the following six years. This is large relative to the sample mean of 1.3%.

On the other hand, if a company survives, dividend recaps also appear to increase the chances of “exceptionally good outcomes” — ie strong revenue growth and IPOs. That might be because dividend recaps make companies more of a binary bet, and encourage it to go for broke. From the paper:

> Having realized good returns from the targeted portfolio company, the GP may encourage its managers to take more risk because the investment’s payoff has become more call option-like.

However, turning to returns, the researchers found that dividend recaps were *positive* for the returns of individual deals, but seemed to be *negative* on a fund’s overall returns. Here’s their explanation for this weird phenomenon:

> At the fund level, we show that dividend recaps decrease the fund’s cash-on-cash multiple and public market equivalent (PME) return measures. There is no effect on IRR, consistent with bringing cash flows forward in the fund’s life. What might explain a positive effect on deal returns yet a negative effect on fund returns? We show that dividend recaps dramatically increase short-term distributions paid out to the fund, which could incentivize the GP to raise a new fund on the basis of good interim returns, consistent with Gompers (1996) and Barber and Yasuda (2017). Indeed, dividend recaps sharply increase the chance of launching a new fund.

> These results suggest that dividend recaps are used to benefit GPs by enabling early distributions and new fundraising. In turn, they may focus their effort more on the new funds. Consistent with this, we observe that dividend recaps cause lower returns for subsequent LBOs within the fund and reduce number of new LBOs pursued, relative to funds of the same vintage.

So what about the impact of people that work at companies that have done a dividend recap?

You'll probably be entirely unsurprised to learn that they are "largely negative", even for companies that survive and thrive despite leveraging up to make payments to the private equity owners.

> We find a large negative effect on wage growth of-53%, relative to a mean of-4%. This is driven by declining payroll, especially at the left tail (i.e., the worst performers among survivors). There is a negative albeit insignificant effect on employment growth, driven by greater chances of being in the tails of the distribution, with a significantly lower chance of modest positive employment growth.
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> Overall, the results suggest that by making firms riskier, dividend recaps raise the specter of bad outcomes for workers — exit, bankruptcy, and significant wage declines — but also increase the chance that the firm experiences a good outcome for owners (IPO, large revenue increases).

Still, at a time when private equity firms are under immense pressure to return money to investors — they've now raised more money than they've handed back for six straight years — and rates are now falling, FTAV suspects that dividend recaps are going to boom even harder in the coming years.

As the paper concludes:

> . . . Our analysis implies that rising CLO demand will increase opportunistic dividend recaps, with negative implications for portfolio company and stakeholders including employees, pre-existing creditors, and fund investors.