Private Equity Pain in Shakeout

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- Lending slowdown to hurt PE-backed companies
- Excess-leverage ‘game’ is ending, according to short-seller

As the panic spurred by the coronavirus erases trillions from equity markets, whipsaws bonds and crushes energy prices, there may still be another shoe to drop.

Short-seller Marc Cohodes is warning that the resulting near freeze in leveraged lending will punish private equity funds that own highly indebted companies. The former hedge fund manager, who now invests his own money, is betting against the industry, which he says is headed for losses as firms mark down holdings.

“They don’t own good assets, they’ve overpaid for things, thrown an awful lot of leverage on them,” said Cohodes, who spent much of his career exposing companies suspected of fraud. “That game is in the process of ending and when it ends, and people can see through it all, they’ll say this marked the end of private equity and the excessive use of leverage.”

The market for leveraged loans -- often used to finance buyouts -- has ballooned over the past decade amid record-low interest rates. But the Covid-19 pandemic has triggered fears of a global recession and virtually shut the markets for such loans and high-yield bonds. Multibillion-dollar loan deals have been canceled, leaving companies unable to refinance.

Worries are growing because of the quality of some borrowers. A Morgan Stanley report in November found that the almost 60% of companies acquired in leveraged buyouts had debt loads above six times earnings before interest, taxes, depreciation and amortization, compared with 51% in 2007.

Investor Bill Ackman also warned of risks to private equity if the crisis persists.

“The airline industry goes bankrupt, the hotel industry goes bankrupt, the restaurant industry goes bankrupt -- and by the way, private equity goes bankrupt,” the founder of Pershing Square Capital Management told CNBC on Wednesday. “Blackstone is a fabulous private equity firm, KKR, they do a tremendous job. But every one of their companies has a lot of leverage. Every one of their companies goes bankrupt if this thing rolls out over 18 months.”

Still, the fund manager has been buying shares of Blackstone Group Inc. amid the sell-off, Bloomberg reported.

Samir Parikh, a partner at hedge fund Islet Management, said many private equity-backed companies refinanced debt over the past year, so they won’t need imminent financing. Islet is wagering on the sector.

How things shake out for indebted companies depends on the course of the virus outbreak. In the short run, banks may ensure access to revolving credit lines and increase them or allow some borrowers to switch to payment-in-kind to preserve cash. Private equity-backed companies could also draw on sponsors for help, but as liquidity issues proliferate more borrowers may eventually default.

Last year, Omega Advisors founder Leon Cooperman cautioned that private equity returns can't last with higher borrowing costs. Falling rates over the past decade were the main reason leveraged buyouts generated high exit multiples, he said.

"I think it's a scam personally," the billionaire said. Returns on "the large deals have been aided and abetted by the enormous decline in interest rates." He later said that while the industry isn't an actual scam, its high fees and lengthy lock-ups don't appeal to him.

For Cohodes, the fallout could be a boon for long-short hedge funds once clients start moving their cash out of private equity and demanding skilled stock-pickers. He's hopeful that in a few months, investors will begin putting money to work.

"Most people are so focused on what's right in front of them that they can't look forward," he said. "If the world doesn't come to an end, if you can find good companies in the Russell index that are down 35%, you should be able to make some money."