Competition & Markets Authority

Mr Darren Jones MP
Chair
Business, Energy and Industrial Strategy Committee
London
SW1A 0AA

From: Dr Andrea Coscelli CBE
Chief Executive

By email

12 July 2021

Dear Darren

Thank you for your letter of 1 July about the CMA's role in respect of leveraged purchases of high street brands.

As you know, in common with other advanced economies, the UK has seen a growth in the number and value of private equity-funded buyouts. Private equity is an important source of business finance but, as you note, these acquisitions can be highly leveraged, which can make the target companies more vulnerable to failure[1]. At a macroeconomic level, rising corporate leverage can also amplify the effects of the business cycle and the impact of economic shocks.[2] Separately, public policy questions have been raised about the possible impact of private equity investment on employment;[3] and the treatment of private equity in the tax system.[4]

The CMA can only respond to these questions insofar as, in doing so, it is fulfilling its legal mandate to promote competition in the interests of consumers, and it is exercising one of its statutory functions. To explain this further, I set out below the two principal CMA functions by which private equity-funded buyouts may fall to be considered by the CMA – merger control and market studies/investigations – and how the CMA may take account of ownership and capital structure in each case.

[1] See, for instance, Cathcart et al (2020) The differential impact of leverage on the default risk of small and large firms, Journal of Corporate Finance, 60.
[2] See, for instance, Financial stability implications of private equity, ECB Financial Stability Review, May 2020.
[3] Goergen et al (2014) The employment consequences of private equity acquisitions: The case of institutional buy outs, European Economic Review, 71.
[4] Financial Times, Long read – Will the UK axe private equity tax break worth millions? 9 November 2020

Mergers

The Enterprise Act 2002 reformed merger control in two important ways. First, it changed the standard by which mergers were assessed from a broad "public interest test" to a more focused "competition test";[5] and second, it made decisions on mergers by the then Competition Commission final, and no longer subject to ministerial approval or alteration (with limited exceptions, discussed below). There was no significant discussion during the passage of the legislation about whether and how ownership models or capital structures should influence merger assessment and decision-making.

Though there have been important changes to the mergers regime since the Act was passed (including the creation of the CMA from the Competition Commission and the Office of Fair Trading), the broad framework, and in particular the substantive "competition test" remains the same today. This means that the extent to which the CMA can intervene in an acquisition on the basis that it is highly leveraged is therefore very limited. The CMA could only do so if it believed that the extent of leveraging could have a substantial impact on rivalry in a market in the UK over time to the detriment of consumers.

In practice this means that the CMA would need to show that the levels of debt being taken on as a result of the acquisition are such that the target would be likely to fail post-merger, or at least that its financial position would be affected to such a degree that it would become a significantly weaker competitor (for example, because it would not be able to make significant investments of the kind needed to continue to be an effective competitor). It will often be difficult to assess at the time of a merger whether gearing will affect a target's competitiveness (and over what time frame), and demonstrating such an effect to the requisite legal standards may therefore be a significant challenge.

The CMA would also need to show that the target's failure (or a significant weakening in its competitiveness) might have a substantial impact on competition in a market, for example by leading to price increases for consumers. The CMA would therefore need to be satisfied that remaining competitors and the potential for entry and expansion would not be sufficient to ensure effective competition in the relevant market regardless of the fate of the target (and the possible acquisition of its assets by other market participants).

[5] Specifically, the requirement to assess whether a merger "operate[d], or may be expected to operate, against the public interest" was changed by the Act to an assessment of whether a merger "has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the UK for goods or services".

Markets

In addition to its role investigating mergers between individual companies, the CMA also has powers to examine markets that may not be working well for consumers and take steps to resolve problems it finds.[6]

Historically, questions of ownership and capital structure (including private equity ownership) have not normally been central to this work because the source of consumer harm has been found to lie elsewhere. But in some cases, they have formed part of the CMA's consideration. For example, as part of its 2017 study into care homes for older people, the CMA assessed how far the debt levels of providers affected the sustainability of the sector, and the ability of the market to meet future capacity.[7] And the CMA's ongoing study into the children's social care market is considering (among other things) whether the status of care providers (i.e. local authority, private equity, non-private equity or third sector) affects the price and quality of the placements they provide and their financial resilience.

In short, the CMA can address concerns about ownership and capital structure through markets work only to the extent that these factors can be shown to harm consumers.

Other powers

Your letter also asked what further powers might be considered to address concerns that might arise from private equity-funded buyouts. In the context of merger control, it is open to Ministers – through secondary legislation – to introduce new "public interest" considerations into statute allowing them to intervene so mergers can be considered on grounds other than the impact on competition. The four public interest considerations on which Ministers can currently intervene in merger cases are national security,[8] media plurality, stability of the UK financial system, and mitigating effects of public health emergencies. In deciding whether to add to that list, there are two points in our view that will be important for Government and Parliament to consider.

- First, one of the justifications for replacing the broader "public interest test" with a narrower "competition test" in the Enterprise Act twenty years ago was that it would make decision-making more predictable, and thereby create a more conducive environment for investment in the UK. While the context may have changed and we have nearly twenty years of evidence from the operation of the regime, the underlying trade-off – between the scope of the grounds for intervention in a merger, and the predictability of the overall regime – still exists.

[6] More information about the CMA's markets powers can be found in CMA3: Market studies and market investigations: supplemental guidance on the CMA's approach

[7] As part of this work, the CMA recommended to the Departments of Health in England, Wales, Scotland and Northern Ireland to establish a market oversight framework to provide early warning in each nation of the potential failure of key providers.

[8] This consideration will shortly be removed from the list in accordance with the National Security and Investment Act 2021.

- Second, the merger control regime can only consider a transaction at a specific point in time. Although Ministers, if they intervene on one of the above public interest grounds, can accept undertakings from merging parties to address that public interest concern (and the CMA can accept undertakings to address competition concerns), these are unlikely to be the best way to monitor or regulate the ongoing behaviour of a business – especially if the concerns relate to broader issues mentioned in your letter such as employment and pension provision. This consideration would not apply though if the outcome is that an acquisition is blocked on public interest grounds.

Finally, I note that consideration has been given elsewhere in government to regulatory issues outside the remit of the CMA which could impact some of the concerns you have raised about private equity ownership models and leveraged capital structures. This is not an exhaustive list and it would be for other bodies to offer advice in these areas but they may include, for example, the relative tax treatment of debt interest and equity returns;[9] the costs and regulatory requirements associated with public listings;[10] and obstacles to pension funds and insurance companies investing in unlisted equity.[11]

I hope that you and your Committee find this response helpful. Please do not hesitate to contact me if you have further questions.

Yours sincerely

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[9] See, for instance, The Mirrlees Review – Reforming the Tax System for the 21st Century, Ch.17
[10] The Hill Review of UK Listings proposed a number of reforms in this area. The Government responded in April. The FCA has also responded and is planning to take forward some of the recommendations through a consultation on primary market effectiveness.
[11] See, for instance, Protecting economic muscle: finance and the Covid crisis – speech by Alex Brazier at the CFO Virtual Agenda, 23 July 2020