
Citation:

Morgan, JA and Nasir, MA (2020) Financialised Private Equity Finance and the Debt Gamble: The Case of Toys R Us. New Political Economy. ISSN 1356-3467 DOI: <https://doi.org/10.1080/13563467.2020.1782366>

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Document Version:

Article (Accepted Version)

This is an Accepted Manuscript of an article published by Taylor & Francis in New Political Economy on 26 June 2020, available online: <http://www.tandfonline.com/10.1080/13563467.2020.1782366>

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Financialised private equity finance and the debt gamble: The case of Toys R Us

Jamie Morgan and Muhammad Ali Nasir

Abstract: In this paper, we pursue a financialisation line of argument exploring the specific features of private equity finance, with a focus on the activity undertaken at scale by the largest management groups or firms. The largest private equity firms wield considerable resources, affect ownership patterns and have the capacity to acquire literally any company. What they do matters. The bankruptcy of Toys R Us and the more general ‘crisis of retail’ illustrate a ‘debt gamble’. A company’s capital structure is radically restructured and equity is reduced and replaced by debt. The gamble is that there will be no change to the external environment that the GP cannot adequately adjust to and that the GP will in fact be able to maintain debt servicing. Although bankruptcy is a ‘worse case’, we contend that from a financialisation perspective, there are a whole set of attendant issues.

Keywords: private equity finance, financialisation, Toys R Us, debt gamble

JEL: A11, A13, G19, G30

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Acknowledgements: thanks to two anonymous referees and the designated editor for constructive comment and insightful suggestions.

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Financialised private equity finance and the debt gamble: The case of Toys R Us

Introduction

In this paper, we focus on the role of private equity finance in shaping contemporary economies. Generically, 'private equity' is a practice via which a management group attract financing, target and acquire a company (delisting it if it was previously public), apply a combination of 'financial engineering' and 'operational restructuring' to that company, and then sell it on. Over the years, private equity finance has accumulated an extensive literature, however, that literature has been mainly produced by relatively few authors; notably, Eileen Appelbaum, Rosemary Batt, Ian Clark, Julie Froud, Karel Williams, Mike Wright, Tim Jenkinson, Ludovic Phalippou, Steven Kaplan, Steven Davis and Michael Jensen. Despite the interest taken in the subject by these and other academics, and despite that private equity finance is a major component in contemporary economies, the subject remains relatively obscure. Accordingly, one purpose of this paper is to draw renewed attention to private equity.

In terms of context, it should be noted that the main literature broadly divides into two perspectives. First, a dominant business school perspective, which places most emphasis on the 'turnaround' of failing companies through operational restructuring and with the aim of realising 'hidden value'. This perspective is most clearly elaborated in a monograph by Gilligan and Wright (2014). Second, a political economy and critical management studies perspective, which places most emphasis on financial engineering, notably the constraining and conditioning effects of the use of debt and the subsequent consequences this can have. This perspective is most clearly elaborated in a monograph by Appelbaum and Batt (2014). The first perspective encompasses work in quantitative finance and economics (e.g. Jenkinson et al. 2016), whilst the second perspective resonates with (and in some cases, constitutes or draws explicitly on) critical financialisation literature (e.g. Clark 2016).

In this paper, we pursue a financialisation line of argument exploring the specific features of private equity finance, with a focus on the activity undertaken at scale by the largest management groups or firms. The largest private equity firms wield considerable resources, affect ownership patterns and have the capacity to acquire literally any company. What they do matters. The bankruptcy of Toys R Us and the more general 'crisis of retail' provides a timely reminder, more than a decade after the global financial crisis, of the potentially adverse influence private equity finance can wield. Highly leveraged takeover activity creates a 'debt gamble'. A company's capital structure is radically restructured and equity is reduced and replaced by debt. The gamble is that there will be no change to the external environment that the GP cannot adequately adjust to and that the GP will in fact be able to maintain debt servicing. Although bankruptcy is a 'worse case', we contend that from a financialisation perspective, there are a whole set of attendant issues. Since our intent is to highlight common issues and draw renewed attention to those issues, we begin by briefly setting out the main components of private equity for the general reader before exploring the dominance of private equity by a few management firms, how financialisation provides insight into practice and how this contrasts with the dominant business school perspective. This progression provides

appropriate context for the example of Toys R Us and the subsequent discussion of the debt gamble. Our concluding point is that the gamble invites public deliberation and this is a matter, following Morrell and Clark (2010), that invokes ethics and the public good.

The three main components of private equity finance

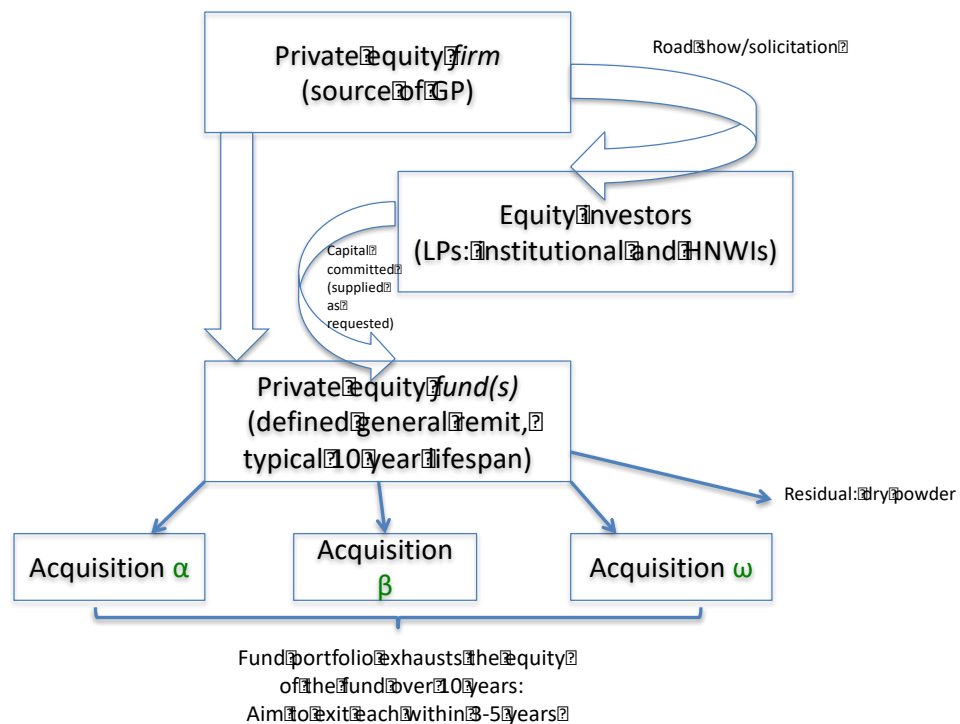
Private equity finance is categorized as part of the ‘alternative investment management’ sector (for book length treatments see Souleles 2019, Phalippou 2017, Appelbaum and Batt 2014, Gilligan and Wright 2014, Morgan 2009, Kosman 2009). As an activity, it consists of three main components. First, private equity management firms. These are the initiating and controlling organizations or groups. These management firms solicit investment capital via networks and through ‘road shows’ from ‘sophisticated investors’ (a technical term for eligible investors and this cannot be ordinary members of the public; it refers, rather, to institutional investors and high net worth individuals - HNWI). The firm provides a group termed the ‘general partner’ (GP) who manage the second component, the private equity fund(s).

Investor’s capital is channelled into an investment entity and investors become the ‘limited partners’ (LPs) of this fund. Funds are typically ten-year entities and, as with private equity firms, funds are often structured as limited liability partnerships (LLPs). The fund is solicited based on a defined investment focus – a country, region or economic sector. LPs sign a ‘memorandum of understanding’ that becomes the basis of a contract and commit a specific capital sum. There may also be a small equity contribution from the management firm. In aggregate this becomes the ‘equity’ of the fund. There is typically a reported target equity sum for the fund, for example, \$10 billion. LPs play *no* role in the fund’s management and they are only required to deliver capital from committed equity to the fund as directed by the GP (termed ‘drawdown’). The unused equity in the fund is referred to as ‘dry powder’. Once the fund is set up the GP begins to look for acquisitions and these are the third component in private equity.

The GP seeks out companies or divisions of companies to acquire. The fund’s first acquisition defines its ‘vintage year’ and this is used as a base year for various metrics. Companies are acquired using a combination of equity from the fund and debt in a ‘leveraged buyout’ (LBO). The LBO begins a process of ‘financial engineering’ of the company. Formally, financial engineering refers to a range of practices and innovations that apply computational, mathematical, and statistical techniques to the finances of an entity or to construct a financial entity (Beder and Marshall 2011). Though the main academic focus of financial engineering is construction (derivatives etc.), the concept also encompasses the radical restructuring of finances and this is a main feature of private equity activity. Debt use creates scope to transform ownership opportunities and banks play multiple roles in facilitating opportunity. Banks act as sources of investor network contacts for management firms. They provide bridging finance and long term structured debt that enables acquisition, and in some cases act as agents of securitization (producing a variant of collateralized debt obligations termed ‘collateralized loan obligations’ or CLOs). They may also be ‘minority investors’ in the acquisition.¹ The GP aims to create a portfolio of companies and use up the equity in the fund in manageable chunks over the ten-year lifespan of the fund. Each acquisition is typically held for three to five years, during which time its operations are also restructured and this covers a range from

changes to products, pricing, numbers employed, employment contracts, work practices, uses of technologies, to supply chains and procurement. The investment is then 'exited' via an initial public offering (IPO), a 'trade sale' to a company in the same sector or via a 'secondary buyout' by another private equity firm. The acquisition process is intended to generate 'returns' to the LPs. Figure 1 summarises the linkages:

Figure 1: Typical components of private equity activity



Source: Morgan 2020

Private equity, scale and power

The brief introduction of the main components of private equity in the previous section is highly generalised. It gives no indication of context, practice or variation. Private equity management firms operate in almost every country. There is, for example, an Emerging Markets Private Equity Association (EMPEA) with more than 300 member firms and reported activity in more than 130 countries. However, the majority of private equity firms are located in the USA and the UK. As previously noted, firms may solicit funds with a primary geographic focus; for example, according to Preqin, 59 Asia-focused funds secured combined capital commitments of \$40 billion in the third quarter of 2019. Many of the firms operating across the globe are overseas offices of USA and UK located firms (however, see Robertson 2013), and based on its (pre-Brexit) financial centre credentials, the UK has been the gateway to private equity in Europe, which has gradually become the second largest and most active private equity market after the USA (see Bain & Company 2019, p. 4, Bedu and Montalban 2014).

According to Preqin and the other main databases for private equity, there are more than 10,000 private equity management firms. However, there are also a few private equity management firms that dominate the sector and which operate at scale and are extremely influential. It is the activity of these that we are interested in.

According to Preqin, total assets under management by private equity stood at \$4.11 trillion in mid-2019, with over \$1.5 trillion available as ‘dry powder’ (Preqin 2020, 2017). Research published in 2015 reported that the top 50 firms account for over 50% of assets under management and the top 10 account for over 60% of that 50% (Jacobius 2015). There is no reason to expect that this general situation has changed. In fact, Preqin refers to a trend of ‘capital consolidation’ and reports that in 2019 39% of capital raised was directed to the top 20 funds dominated by the main firms (compared to less than 30% five years previously).

If one surveys the top 10 firms in 2019, each had more than \$50 billion in total assets under management, and the top five more than \$100 billion. Blackstone alone raised over \$115 billion in fund solicitations 2005-2015. According to the ‘PE 300List’, compiled by *Private Equity International* magazine, Blackstone is the largest alternative asset management firm in the world – with over \$570 billion in assets under management at the beginning of 2020, if one includes its hedge funds (Carlyle Group is historically larger for private equity alone). Blackstone’s Capital Partners VI fund closed at \$16.2 billion in 2010, and Partners VII closed late in 2015 at \$18 billion. In September 2019, Capital Partners VIII was reported at \$26 billion, exceeding both its initial solicitation of \$22 billion, and the previous record held by Apollo Management of \$24.5 billion in 2017. The top 10 largest individual funds solicited by private equity firms are all larger than \$15 billion and the majority of these have been closed since 2013. Any fund of \$10 billion or more is categorized as a ‘mega fund’ and there are now many mega-funds.

Two important points follow from this domination of private equity by, and concentration of capital with, a small group of firms and their funds. First, the existence of mega-funds creates an *incentive* to act at scale, since the GP must aim in principle to use up the equity in the fund and there are only so many companies (perhaps ten to twenty) that can be manageably targeted, researched and then subject to financial engineering and operational restructuring by a small GP team over the relatively short period of 3 to 5 years and within a ten-year time horizon for each managed fund. Second, private equity management firms not only have incentives to act at scale they have the *means* to do so. GPs can call on equity from several mega-funds and combine this with debt in an LBO. Moreover, the top firms tend to collaborate as bid ‘consortia’, since this spreads risk and reduces competition. As such, acquisitions in the tens or hundreds of millions of US\$ or equivalent are quotidian and GPs can readily target acquisitions in the billions. Based on Preqin annual reports, in both 2016 and 2017, though transactions over \$1 billion were only 10% of the total number of acquisitions, they constituted over 60% of the total value of activity. In principle, then, private equity firm consortia using multiple mega funds and debt could acquire literally *any* company. For example, TXU Corporation (renamed Energy Future Holdings) was acquired by a consortium of KKR, TPG and Goldman Sachs for \$48 billion in 2007. This remains the largest single transaction, but prominent multi-billion acquisitions have continued since the financial crisis (two of the largest in 2018 were the buyout of Thomson Reuters’ financial risk unit for \$17 billion and of Envision Healthcare for \$9.6 billion).

Clearly, over time, private equity has had great scope to influence economies through patterns of ownership. According to Bain & Company, private equity activity accounted for approximately 10% of annual global merger and acquisitions 2004-2018 and much of this, particularly the ‘high value deals’, has been undertaken by the top firms (Bain & Company 2019, p. 5, figure 1.3). As of February 2020, Carlyle, for example, listed 638 investments undertaken since 1996 using 374 investment vehicles. Its current portfolio stood at 214 investments, operating out of 33 offices on six continents and it

reported more than 2,600 investors from 94 countries.² Carlyle has one of the larger historic and contemporary portfolios but others too are significant. Apollo Global Management lists more than 150 historic investments undertaken since 1990.³ Much of the activity, however, is twenty-first century and over the last twenty years, private equity has become a major employer in the world. KKR alone owned or co-owned companies employing approximately 900,000 in the USA during the first decade of the 2000s. According to Hammoud et al (2017), if one aggregates the portfolio acquisitions of the top five private equity firms, then just the top five would make private equity the second largest private sector employer in the USA (behind Walmart) and the largest in Europe.

It follows, then, that what private equity management firms do matters. However, the combined significance of private equity is not readily visible to the public. Blackstone, Carlyle, Apollo, Bain, KKR, TPG, CVC, Permira, Silver Lake and others may be familiar names in the business press, but the organizations they acquire do not carry their names, so the *collectivisation* of ownership remains relatively opaque. The public are only peripherally aware that many well-known names have been or remain private equity owned: Hilton Worldwide, Heinz, Dell, First Data, AA, Yell, Boots, Debenhams, Iceland Foods, BUPA Hospitals and many others.

Public awareness of private equity tends to be brief and sporadic, often emerging at points of financial crisis and private equity practitioners, industry representatives and lobby groups tend to respond through image restructuring. The term private equity became current in the 1990s and was itself a response to the negative ‘asset-stripping’ publicity that surrounded ‘leverage buyout’ firms in the 1980s – including the aftermath of the Savings & Loan crisis (Morgan 2009). More recently, industry lobby groups have tended to drop the term private equity from banners and emphasise venture capital or more neutral terms for investment capital. An enduring feature throughout, however, is the use of debt in the initial acquisition process and the broader context of subsequent financial engineering. The practices and incentive structures of private equity can lead to significant debt servicing burdens on acquisitions, creating new constraints and vulnerabilities, and those practices and incentive structures clearly fall under the remit of financialisation.

Private equity and financialisation

Interest in the role of finance capital has a long tradition in social science, but was relatively neglected in the latter half of the twentieth century. However, following the special issue of *Economy and Society* in 2000 and the publication of Gerald Epstein’s edited text, *Financialisation and the World Economy* in 2005, its role has become a major focus for theory and research in various strands of political economy and critical management studies. Financialisation is generically defined as a tendency towards the subordination and reconstitution of economic activity based on the influence of financial organisations, actors, and interests (Epstein 2005). A variety of specific theory and foci have emerged to explore this, but all share a common interest in the growing *power* of financial agents to structure and influence the wider environment. As Natascha van der Zwan states in her highly regarded survey essay, financialisation has recently been explored according to three different though related themes: the whole socio-economic system of accumulation, the firm and its organisation, and the diffusion of finance, its practices and culture into the ‘everyday life’ of the individual and household (van der

Zwan 2014). A financialisation focus has brought numerous insights. For example, in 2007, Julie Froud and Karel Williams, working at the Centre for Socio-Cultural Change (CRESC) at Manchester University, produced one of the first contemporary papers to draw a connection between the power of finance capital and private equity. They state, 'private equity represents a rearrangement of ownership claims for value capture which then allows value extraction ... the legacy effect of private equity is likely to be a cultural shift which normalises value capture insofar as it helps to institutionalise and normalise value extraction.'

The build-up to the global financial crisis was a period when private equity was experiencing an unusual level of public scrutiny in the UK and USA, and the work of CRESC has provided an important series of interventions (see Erturk et al. 2010, Froud et al. 2012, Burns et al. 2016). The issue of value capture and a cultural shift has proved particularly insightful in the wake of the financial crisis – not least because recession, slow growth, austerity, precarity and wealth and income inequality have become major issues everywhere. In a series of subsequent works, for example, Ian Clark has confirmed that value capture and value extraction remain substantive issues for private equity activity (Clark 2016, 2013, 2011, 2009). He finds that private equity activity has 'contagion' effects that shape the specific practices engaged in by companies, but that this, in turn, sits within the broader framework of interests of the combination of private equity management firms and funds (Clark 2016, p. 240). According to Clark, this weakens the relationship to, and influence of, other 'stakeholders'. Again, this has context. As Arne Kalleberg (2015, p. 218), well-known for his work on precarity, states in his review essay of Appelbaum and Batt's *Private Equity at Work* (2014), a 'key aspect of the financialisation of the American economy was the emergence of private equity (PE) firms in the 2000s', and private equity is one component in a shift from 'managerial capitalism', whose *primary* focus of ownership is producing particular goods and services in specific markets, to 'financial capitalism', where the producing organisation is treated primarily as a tradable asset. In similar fashion to Clark, Appelbaum and Batt explore various aspects of the effects of this 'financial capitalism' for employment relations (see Appelbaum and Batt 2019, 2016) and share common concerns that fall broadly under the remit of the concept of financialisation (see their collaboration, Appelbaum et al. 2013).

The common thread we want to draw attention to is that private equity treats an acquisition as a financial instrument in a portfolio for the purposes of the managers of the private equity fund and the investors in the fund (see Morgan 2020, 2009, Robertson 2009; Scheuplein 2019). As Froud and Williams (2007) note, private equity reverses the typical capital structure of public companies – debt dominates equity, and this structure flows from the interests of financial agents. Though financialisation can apply to investment in public markets, it is important to recognise that the relation of private equity ownership is different. Institutional investors, for example, affect publicly listed companies via the trading of equity and through governance processes, generically termed 'shareholder activism'. Whilst these investors may own a portfolio of shares, they are *additional* financial agents who do not entirely own and control the entity invested in. By contrast, private equity firms and funds comprise financial agents who own and control that entity. The fund (or funds) own the acquisition and the GP controls it through a holding company. The ultimate goal of ownership is to generate a return *to the private equity fund* – from which the LP and then the GP profit. Ownership of the acquisition is a means to *this* end. The intention is to achieve a profitable outcome for the fund over a 3 to 5 year period of ownership. Based on a financialisation perspective, what we want to

emphasise is that debt is initially a means to achieve ownership and its use has consequences based on the incentive structures that are basic to private equity at scale.

Financialisation, shareholder value and debt

According to Froud and Williams (2007, p. 407) 'the discursive promise of private equity is about general benefits from the value creation consequent upon a new way of relating finance and management'. This 'promise' is rooted in Jensen's (1986) agency alignment argument. Whilst Jensen's work is no longer the only approach to corporate activity in business schools, for private equity it remains the dominant perspective. Though the idea of stakeholders is not neglected, alternative investment organizations, lobby groups and academic proponents make frequent reference to the core concept of an aligned 'shareholder value' maximisation (for example, Kaplan et al. 2011, Jones et al. 2006). For critics, this is quintessentially a feature of financialisation. For proponents, the intervention of the fund follows a 'competition for control' procedure and the acquisition represents a consolidated and streamlined ownership situation. Ostensibly, the 'alignment' is between GP and LP and this is 'close'. In the standard argument, this is because the GP earns 'carried interest' based on the return to the fund. This provides context for Froud and William's new way of 'relating finance and management'.

Carried interest is a performance based payment; a contractual percentage sum paid to the GP from the return to the fund. This is typically set at 20% of the return, but is usually subject to a 'hurdle' or threshold percentage return to LPs that must be exceeded before carried interest applies. The hurdle is set at a level that exceeds what might be earned from some low risk, standard investment. From a financialisation point of view, it is significant that the alignment is *focused on the fund* and, to reiterate, the acquisition is a means to achieve the ends of the fund. As Clark, Appelbaum and Batt and others argue, it does not follow that any changes made to the acquisition are in the immediate or long-term interest of that acquisition or its stakeholders other than the GP and LP (Morgan 2020). Whether changes are beneficial is in some sense an empirical issue, but from a financialisation perspective, the issue is preconfigured by the general structuring of private equity, and this begins with the way ownership is achieved.

Ownership is achieved using a leveraged buyout (LBO). The LBO begins the financial engineering of the acquisition and serves a primary function in terms of the fund return structure. The use of debt reduces the sum of equity required from the fund in order to achieve the buyout. This shrinks the relative proportion of equity represented in the sum of the buyout (a 'concentration' of equity, which transforms the capital structure). In turn, this reduces the time line over which it is possible to return the equity to the fund, based on income streams drawn from the acquisition. 'Concentration of equity' accelerates the rate at which the fund can recoup its equity and this is conducive to the target holding period of 3 to 5 years. Concomitantly, the engineering increases the return on investment (ROI) and means that once this reduced equity sum is returned, any further income that flows to the fund is profit. Clearly, the sale of the acquisition is liable to be more profitable if the equity is all returned prior to exit, though this is not the only option open to the GP.

In any case, in private equity, the specific consequences of debt use depend on the terms and conditions of the debt. Overall, the GP must balance using up the equity in the

fund and concentrating the equity in each acquisition, reducing the proportion of equity to debt. This latter shift increases the scope for returns to be made from each acquisition. Moreover, the fund and firm have limited liability. Once the LBO is completed, it is the *acquisition* that is responsible for the debt. The creation of a holding company creates a break as well as a conduit between the firm, its managed fund and the acquisition. The debt is attached to the acquisition, which is ultimately partly acquired using itself as collateral. The only risk to the fund is the potential loss of the sum of equity used.

Financialisation and the debt gamble

The point we want to emphasise here is that debt plays a pivotal role in creating opportunity for the GP. Moreover, though the term ‘financial engineering’ may connote an activity pursued with scientific precision, there is an important distinction between the precision of the execution of the skillset and the prior incentives to make use of currently available credit conditions. Financial engineering may be highly quantified, but the decision regarding how much debt to use is conditional in a less precise sense, and the incentive structure of the GP as a financial agent tends to result in *more* debt use than might otherwise be the case. To be clear, there has been a trend over recent decades for corporate debt levels to increase in general and financialisation literature provides various explanations for this, such as global tax avoidance strategies, dividend payment pressures and stock buyback activity, but private equity still leads to comparatively higher levels of carried debt. Notably, both proponents and critics acknowledge this.

In an LBO, leverage is typically defined as the percentage of debt used to achieve acquisition. It can be expressed as the percentage of debt in total capital, and may also be expressed as a ratio of debt to equity or as a multiple of some significant metric for revenue, such as EBITDA, since this can signal total debt’s likely significance for debt servicing. Using a dataset of private equity LBOs from 1980-2008, Axelson et al (2013) find 70% average debt to total capital (and a ratio of 5.2 to EBITDA). This contrasts with a later study by Gompers et al (2016, p. 460), which finds an average of 60% of debt and ratio of 4 for EBITDA.⁴ *Both* are high in comparison to other ownership forms, but the significant difference between the two studies is that the Axelson et al dataset runs to the global financial crisis, whilst the Gompers et al runs to 2012. The period 2001-2008 was one of loose credit conditions. From a financialisation perspective, the clear inference is not just that leverage levels vary with available credit conditions, but that there is a tendency to *exploit* available credit, and this is subtly different – it speaks to an adverse structuring incentive – the risks that will be taken to achieve returns to the GP and LP. According to Appelbaum and Batt (2014), typical debt was as high as 90% of the buyout in the 1980s, and has varied since. From a financialisation perspective, private equity seems structurally disposed to use available credit and push levels of leverage when able to do so because of the scope to structure financing to accelerate returns to the fund whilst achieving carried interest and because the acquisition carries the debt and the GP and fund have limited liability.

It should be clear, then, that the ‘alignment’ of interests focused on the fund encourages the use of *more* debt than a different kind of organizational structure might consider prudent. Debt is basic to seizing control of the acquisition and greater use of debt increases the rate at which the investment becomes potentially profitable to the

fund. Also, by using more debt, risk is tacitly transferred from the fund to the acquisition. Debt creation and debt servicing are, therefore, crucial issues.

Fundamentally, from a financialisation point of view, private equity activity, where significant leverage is used, gambles with the future viability of acquisitions and it is the larger management firms that are able to use more leverage and who are engaged in the acquisition of larger companies. The gamble is that there will be no change to the external environment that the GP cannot adequately adjust to and that the GP will in fact be able to maintain debt servicing. However, these are conditional on factors that can escape the control of the GP in two senses. First, refinancing may become a problem, subject to subsequent reversals in the terms, conditions and availability of debt. From a financialisation perspective, private equity activity is part of debt *processes*. Its activity thus resonates with Charles Kindleberger's historic work and Hyman Minsky's theorisation that financing evolves, debt accumulates in the system and problems or crises necessarily follow, albeit these issues are not restricted to private equity (however, see Gregory 2013). Second, for any given acquisition, debt servicing may reduce the margin of safety the acquisition has before it becomes 'distressed' *if* the environment changes, whilst also restricting the capacity to respond to those changes, *and* this problem does not necessarily disappear when an investment is 'exited' because debt may be carried over by the former acquisition.

Though debt is a crucial issue for private equity, its significance is different when placed in a dominant business school perspective. As we suggested in the introduction, this perspective places most emphasis on the 'turnaround' of failing companies through operational restructuring and with the aim of realising 'hidden value'. However, one must avoid traducing those who adopt this perspective. Proponents do not neglect financial engineering, even when their work derives from research centres funded by industry practitioners, banks and so forth (such as the Centre for Management Buyout Research in the UK, founded by Mike Wright in 1986). Rather, the use of debt and the role of financial engineering are either subtly de-emphasised or framed as unproblematic, though what this means requires further explanation.

Debt can be de-emphasised through language use and framing of its relative importance. For example, in the Gilligan and Wright (2014) text *Private Equity Demystified*, when the initial concept of private equity is introduced there is great emphasis placed on the diversity of investors and the long-term nature of the investment (ten years). The main focus is the status of private equity as 'risk capital', whose goal is to increase 'shareholder value' through a return on capital, implying the fund achieves its return on the turnaround and sale of the acquisition. As Daniel Souleles (2019) notes in his ethnographic work on private equity, this closely follows the practitioner narrative, which places great emphasis on value creation and where a *systematic* or shared downside is often only acknowledged in private or through collective humour (Souleles 2017). In the Gilligan and Wright text it is almost in passing that leverage is acknowledged, at 'the same time that a private equity fund makes an investment in a private company, there is usually some bank debt or other debt capital raised to meet the part of the capital required to fund the acquisition. This debt is the 'leverage' of a leveraged buy-out' (Gilligan and Wright 2014, p. 14). The use of 'usually some' is not incorrect, but nor is it accurate if by that we mean it highlights the relative significance of debt.

To be clear, however, those who adopt a dominant business school perspective do not necessarily confirm the most flattering claims made by the alternative investment management sector. Much of the work on private equity finance in business schools derives from financial economics and quantitative finance (and this includes the Axelson et al and Gompers et al referred to previously). It cannot ignore the way debt is used to capture control of companies or the role of financial engineering. However, the work has two main focuses. First, it tests the conformity of private equity finance to standard finance and economic theorems, and in economics the primary context for this is degrees of deviation from hypothetical 'efficiency' or optima. Issues of power, structure, and ethics sit awkwardly with this tradition of theory and as Clark notes (2016), following Mazzucato (2015, 2018), mainstream economic theory has taken little interest in the difference between wealth capture and wealth creation. For this one must look to political economy, for example, Seabrooke and Wigan's (2020) work on Global Wealth Chains, which shifts the emphasis from Global Value Chains (Morgan 2020).

By contrast and based on the body of theory it emerges from, the dominant business school perspective is interested in private equity as an asset class, and this influences its second focus, its approach to evidence. If one begins from a focus on private equity as an asset class, then the main concern readily becomes the performance of private equity as an investment and the various related quantifiable issues that might affect this. For example, Steven Davis at University of Chicago has done extensive collaborative work on employment impacts and the long-term growth trajectory of private equity acquisitions (Davis et al. 2014). Though this may seem to cover similar territory to work in political economy and critical management studies, the actual focus sits comfortably with the main body of business school theory and the concern and funding that typically follows corporate finance. So, whilst empirical findings may vary, private equity is treated as simply another aspect of normal financial practice.

Financialisation questions what it means for practices to be *normalised*, it considers power, structure and ethics. In the dominant business school perspective, since private equity is merely one normal practice, the construction of its empirical variation is subtly affected: it experiences abnormal times along with other aspects of finance, but any problems share a similar narrative of deviations from best practice, poor choices and learning experiences. For example, in the language of the discourse, the buyout market 'overheats' and private equity is undermined as an 'engine of efficiency'. As such, the framing shifts attention from the collective and ongoing issue of problems. Financialisation is different as a perspective.⁵ It highlights the common and enduring problematic features of private equity and ultimately questions the norms. The recent failure of Toys R Us can be used to illustrate this. Toys R Us is, in one sense, a 'worse case' that illustrates both factors that can go wrong in the debt gamble. But it is more than this, it illustrates the problem of a common implicit business model, and the consequent problem of private equity convergent practices at scale.

Toys R Us: A worse-case scenario of financialisation?

In order to appropriately explore the case we first need some context regarding how Toys R Us came to be a target for private equity, since this speaks to a common model and convergent practices. Toys R Us was founded in 1948 in the USA and was an early adopter

of the out-of-town retail park superstore format. Based on economies of scale and extensive in-store inventory, this format offered low cost and extensive choice (e.g. Nicolaou and Scannell 2017, Spross 2018, Stevens 2018a, 2018b). Successful application of the format enabled Toys R Us to expand to become the dominant multinational in toy retail. By 1998, the business had 1,452 stores worldwide. However, by that year and based on aggressive discounting, Walmart had overtaken Toys R Us as the biggest toy retailer in the USA and the dot.com boom had begun. Toys R Us began to provide on-line retailing in 1998. There were immediate implementation problems and in 1999, EToys, a new competitor platform, went public with a larger market capitalization than Toys R Us.

Toys R Us responded by entering a ten-year agreement with Amazon to be its sole supplier of toys. However, Amazon began to offer products from competitors, claiming that Toys R Us' inventory was not comprehensive. Thus, as Amazon rapidly expanded, Toys R Us was tied into Amazon and its brand and sales potential were diluted. Toys R Us remained a major retailer in the early 2000s but its market share and, as a result, its share price went into decline (Rozhon and Sorkin 2005).⁶ This, its extensive worldwide property portfolio and its positive cash flow (albeit based on margins that other superstores and the new on-line platforms were thinning) made Toys R Us a prime target for private equity.

The point to bear in mind here is that for private equity, debt is used to capture control of a target and so financial engineering precedes any operational restructuring that may occur. Financing must be available for the target and the target must be able to debt service for the anticipated period of ownership prior to 'exit'. Given the planned radical change to the capital structure of the acquisition, these are not insignificant issues. At scale, the GP will be looking for targets that have collateral or assets, such as land and property, and reliable income streams, such as long-term public-private contracts or high profile branding, consumer loyalty and some form of market power. These primary concerns must then coincide with some recognisable opportunity to acquire control of the target, such as weak governance or a falling share price. Governance problems and share price discontent reduce resistance to a buyout and provide some receptivity for any stated plans to address underlying issues such as market share. In the case of Toys R Us, the founding CEO retired in 1994, and his chosen successor was replaced by a rapid series of non-sector experts after 1998. By 2005 the company's share price was hovering around \$23-\$24 compared to a high of \$45 in 1993.⁷

However, it should be clear that the interest of private equity in targeting a company does not imply that the target need be 'failing' in any fundamental sense or that there is necessarily 'hidden value' in any ordinary language sense that a member of the public might expect – where the intent of ownership is purely to profit by transforming the operational structure of the business. 'Failing' and 'hidden value' are ambiguous terms once placed in the context of the primary concerns that are built into the needs imposed by the act of wealth capture, i.e. to radically restructure the finances of the target. GPs are not looking for failing companies per se, but rather they are looking for companies that are vulnerable to takeover and have common characteristics conducive to a common set of practices engaged in by the larger private equity firms. Debt servicing is fundamental.

Between March and July 2005 Toys R Us was acquired by a consortium of KKR,

Bain, and the New York property company Vornado Realty Trust. Financial statements and analytics available from DataStream, and other sources clarify the basis of the financing (Thomson Reuters 2019, Nicolaou and Scannell 2017, Hartung 2017). The sale was agreed at \$26.75 per share, an 8% premium to the closing share price after rival interest from Cerberus Capital. The initial buyout cost approximately \$6.6 billion and each party put in an equal equity share (KKR drew mainly from its Millennium fund and Bain from its Capital VIII fund) to a combined total of just under \$1.3 billion.⁸ The remaining \$5.3 billion of the transaction was structured as debt and Toys R Us was already carrying just under \$1 billion in debt. Accordingly, following acquisition, total debt had increased to \$6.2 billion and the new entity had an estimated leverage level of 83%. Given an average interest rate on the debt of about 7% in 2005 the acquisition faced initial annual debt servicing costs of around \$450 million. According to the company's SEC 10-K filing for the financial year to January 2005, net sales revenue was \$11.1 billion in 2004 and operational earnings 2.7%.⁹ As such, the estimated new total for debt servicing stood to more than consume current profits at the time of the takeover.¹⁰ However, management continued to financially engineer the acquisition after the takeover.

GPs typically formulate a 100-day plan to restructure acquired companies and securing debt servicing tends to be at the heart of the plan. The plan typically also involves making use of economies of scale available to large private equity firms based on their portfolio (enabling cost reductions for standard office goods and some inventory), as well as new investment. However, there is little incentive to engage in forms of investment that will not realise significant benefits within the likely holding period and, Gilligan and Wright's (2014) claims notwithstanding, that holding period is intended to be relatively short if one is thinking about the required duration of basic research and development or major construction or business infrastructure projects. There is, rather, a strong incentive to focus investment and innovation on immediate rationalisations that affect cost structures. This is because cost savings free up cashflow to support debt-servicing and may also provide scope for special dividends to be paid to the fund. Prior to the buyout, Toys R Us reported cash and equivalents of \$2.2 billion and following standard private equity practice this was run down. Concomitantly, the company reported reduced total assets of \$2.8 billion in 2006 against \$4.7 billion in 2004 as the company restructured its property portfolio.

Over the next decade Toys R Us net sales fluctuated between a high of just under \$14 billion and \$11 billion, but tended closer to \$11 billion in 2017. In EBITDA terms the company remained broadly profitable. The company did invest after 2005. However, this was mainly in the form of supply chain management for 'lean' operations. This too is important and speaks to issues of common practice. Not only does financial engineering precede any operational restructuring that may occur, the constraints imposed by it are likely to condition any operational restructuring. This is a point made repeatedly across the financialisation literature. It parallels, for example, Clark's argument that there is a contagion effect and an implicit business model imposed by the interests of the financial agents following 'balance sheet restructuring' (Clark 2009, 2013, p. 157, 2016).

As numerous sources confirm, Toys R Us consistently failed to address the core challenge of transforming stores from inventory stacked warehouses into attractive themed play experiences, failed to respond to the digital transition (electronica, gaming etc.) and failed to develop an effective companion e-commerce business – the twenty-first

century retail business model ‘multi-channel’ challenge (Wahba 2018, Nicolaou and Scannell 2017, Hartung 2017).¹¹ This was despite suing Amazon in 2006 for reneging on their initial agreement and despite buying up other on-line platforms, including EToys. In 2009 Toys R Us was awarded \$51 million in damages from Amazon.

In 2010 Bain, KKR and Vornado prepared Toys R Us for exit via an IPO. This followed the standard exit time line of 3 to 5 years. However, the IPO was abandoned once it became clear there was insufficient demand for the offering. One way to look at this is to infer that the original acquisition was predicated on the long-term appreciation of commercial property. This is typical in private equity, since it provides a rationale for future financing activity. Again, typically, this has involved disposition of property and splitting property off into a separate entity that could earn rents. More basically, the fundamental assumption is that any necessary refinancing will always be possible because one can collateralise it against rising property values.

However, commercial property valuation was affected by the global financial crisis, and the problem was exacerbated by the incremental shift on-line of retail. Not only does this affect the attractiveness of an IPO it also reduces the scope for a secondary buyout and the potential for a trade sale (to an equivalent entity). The consortia thus found themselves carrying the acquisition beyond the standard period. Debt servicing was a continual problem and the need to refinance when the principal reached maturity was a recognizable periodic problem.

Debt servicing and the debt gamble

Toys R Us clearly illustrates the two features of the debt gamble we noted could escape the control of a GP. First, how refinancing is situated to historical processes that private equity is itself a major contributor to: the expansion of debt processes leads to reversals affecting the systemic scope for refinancing. Second, how debt servicing pressures can influence the scope for investment and reduce the margin of safety the acquisition has before it becomes ‘distressed’ *if* the environment changes.

Based on SEC 10-K filings, interest expenses from 2007 to 2017 reported by Toys R Us were consistently higher than \$400 million per year.¹² From 2014 the company began to report net losses. Business analysts began to identify the company as susceptible to debt distress and noted that tranches of long-term debt were due for refinancing in late 2017 and in 2018. In the autumn of 2017 several suppliers in the USA began to restrict delivery of inventory and require upfront payments. In September 2017 Toys R Us filed for Chapter 11 bankruptcy protection in the USA in order to restructure. Arrangements such as Chapter 11 exist to expedite transfer of ownership. This is predicated on the distinction between ‘financial’ causes of insolvency and ‘economic’ causes. Creditors, current owners or other parties who can renegotiate credit terms assume control of the entity. From a dominant business school perspective, the main issues are ‘transaction costs’ created by the transition. However, from a financialisation perspective there may be a conceptual distinction between financial and economic causes of insolvency, but there is a real interdependency between the two.

In any case, the worldwide entities of Toys R Us initially continued to trade based on separate arrangements. However, the UK entity had already posted a £673 million loss for 2016.¹³ With this and the USA action as context, in October suppliers similarly

restricted delivery in the UK and in December 2017 the UK entity filed for a company voluntary agreement (CVA) to enable it too to negotiate with creditors and restructure.¹⁴ However, with more than £50 million due immediately in payments for tax and debt the UK entity entered administration in February 2018. The USA entity collapsed in March 2018, and with no buyers for either business (or significant chunks of it), both the USA and UK entities were wound down in administration 2018 (and as of early 2020 several hedge funds are in dispute regarding debt ownership). In announcing the Chapter 11 filing of Toys R Us, David Brandon, the CEO was quite candid; it was 'over-leverage' and 'debt-servicing' that forced the decision.

The collapse of Toys R Us resulted in the closure or disposal of almost 900 outlets in the USA and another 105 in the UK. It placed 65,000 jobs in jeopardy worldwide and within this number put 33,000 employees in the USA and 3,200 in the UK into redundancy. In the UK, following a well-publicised pension deficit debacle the closure also resulted in the transfer of its failed pension scheme to the Pension Protection Fund. Every outlet closure represented a contraction in a local economy. Toys R Us very clearly illustrates what can happen when private equity engages in financialisation of the firm. It is in one sense a 'worse case' because the result was insolvency.¹⁵ However, in context, as an example of private equity financialisation, it illustrates more than this. Toys R Us may be a worse case in terms of consequence but it is *not* an aberration in terms of business model and practice.

Retail has been a common target based on common interests of private equity management firms. Property assets and ostensibly reliable income streams against a background of consumption economies, made retail particularly attractive to private equity before the global financial crisis and just after (for different reasons based on expected recovery prior to austerity). Retail has had characteristics that facilitate financing, but the extent of private equity involvement in the sector has remained obscure precisely because acquisitions retain their trading names. Private equity activity is convergent and its collective consequences can be severe. As Wahba (2018) notes, 10 of the 14 biggest retail bankruptcies in the USA between 2012 and 2017 were private equity backed. In the UK, many major retailers have been private equity owned and financially engineered at some point over the last fifteen years. One could, for example explore similar themes for Debenhams, which never really recovered from the debt legacy of its 2003 LBO and 2006 IPO, and now limps on after going into administration in April 2019.¹⁶

The retail sector in many countries is undergoing major transformation, but the market for goods, including toys, has not disappeared nor has it all entirely transferred on-line. It is not inevitable that Amazon simply becomes the market and if it were not for onerous debt-servicing then Toys R us would likely still exist in some form – surviving to innovate and adapt, much as cinema did to video and then to home streaming. It is surely the case that the lack of public awareness of the extent of collectivised ownership by private equity has helped its firms avoid taking responsibility for their role in creating the debt carried by companies in what in the UK is now referred to as the 'crisis of the high street' or 'death of retail'. Private equity does not have to be the sole influence for this to be significant. Social reality is a complex open system involving multiple influences. As a report from Bloomberg analysts makes clear, the use of significant debt can become a primary material influence (Townsend et al. 2017). They report that, based

on past convergent behaviour, an *annual* average of just under \$5 billion in retail debt (categorised as 'high-yield') will become due in the USA between 2019 and 2025. This contrasts with just \$100 million in 2017 and \$1.9 billion in 2018. According to a recent Bank of England (2019) *Financial Stability Report* there is now more than \$3.2 trillion in outstanding leveraged loans, globally. The *Report* highlights that the loans are poorly regulated, not well measured (and so the total may be greater), and a significant part of the total is 'covenant-lite', rendering it intrinsically difficult to monitor and higher in risk.

In any case, in so far as the underlying interests and focus of private equity remain the same, there will be new common target sectors in the future. If one surveys private equity trade media then a major current focus is infrastructure, based on the premise that President Trump has galvanised interest in this in the USA and the interest generalises, based on a decade of underinvestment across major economies and the likely need for responses to climate change in the next 30 years. Blackstone and others are positioning themselves to exploit future contractual monopolies and public-private initiative opportunities (despite, in the UK case, the recent failures surrounding Carillion and similar companies). Blackstone is currently soliciting a Blackstone Infrastructure Partners fund and is aiming for a record \$40 billion.

Whilst it is too soon to know how the global Covid-19 pandemic will affect private equity activity, it is clear that the suppression of economic activity has had immediate consequences for current acquisitions, intensifying underlying debt servicing vulnerabilities (and at the time of writing Pizza Express, for example, in the UK had become a subject of interest for the business media for this reason) and it is equally clear that private equity will seek out new opportunities, as corporate revenues come under pressure. However, overall, it is by adopting a financialisation perspective that collective problems of the debt gamble become clear. Clear, of course, does not mean 'settled'. The claim that there is a debt gamble necessarily invites counter claim, most notably the mainstream 'debt discipline' argument (Jensen 1993) and there are also multiple arguments regarding the role of management, monitoring and service fees applied to GPs and acquisitions and all of these invoke agency issues (in the '2 and 20 model'). There is not scope to discuss these here, but they are addressed in the critical literature. The underlying concern, meanwhile, follows from Froud and Williams (2007) early statement on debt and 'institutionalisation', and we briefly conclude with the normative issue of tacit entitlement that arises here.

Conclusion

Private equity demands our attention. What its management firms do matters and as we have argued a debt gamble is at the heart of this.¹⁷ However, from a mainstream business school perspective, private equity is normal, merely one more component in the finance system. From a financialisation perspective, however, the normalisation of some of its practices contributes to the pathologies of that system, and practices are not acceptable merely because they are normalised, they require justification. Ultimately this is a matter of ethics. However, as Morrell and Clark (2010) have argued, agency alignment theory may have an implicit ethical position (the perspective of its few financial agents), but is not itself appropriately framed as ethical inquiry, and so is not conducive to exploration of the issues:

The key question is not, 'how is private equity more efficient than other more established business models?' nor is it, 'how does private equity improve the performance of under-performing firms?' or 'how can we improve private equity?' Instead, it is 'what are the wider costs and benefits of the various forms of private equity?' (Morrell and Clark 2010, p. 260)

For Morell and Clark, the kind of issues we have explored in this paper 'potentially compromise the wider public good', and they offer virtue ethics as a way forward. Still, the public good requires public awareness and discussion, and the debt gamble seems ripe for public deliberation. Arguably, the debt gamble raises the issue of entitlement (Morgan 2009, p. 231). The fundamental issue is not whether private equity activity can be loss making to the management firm and its funds, but whether private equity should have the *right* to engage in the activity as is. This is a matter of the values we want to inculcate in society, but one can pose a simple question: is there anything that could not be achieved in terms of the 'turnaround' (or more generally, development) of a company based on less debt, no debt and under different forms of organization and incentive structures for acquisition? Furthermore, one can extend this question form: are there reasons to prefer alternatives?

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¹ Minority investor is a legal term; the investor has no voting rights.

²See:

https://www.carlyle.com/our-business/portfolio-investments?search=&alphabet=All&location=All&industry=All&status=All&fund_type=All&page=0

³ Consult: <https://www.apollo.com/our-business/private-equity>

⁴ Note, Gompers et al is a survey, so the dataset is slightly different.

⁵ However, see Appelbaum and Batt (2019).

⁶ In 1993 Toys-R-Us sales constituted 21% of the US toy market whilst in 2005 this was 17% (compared to Wal-Mart at 25%). As the sector consolidated the company did not experience collapse, Amazon expanded to capture most of the sector.

⁷ The company appointed Credit Suisse 2004 to explore the possibility of a buyout. Once this became public it had an immediate effect on share price – causing it to increase by about 50% over twelve months.

⁸ According to the SEC 10-K filing of the newly consolidated acquisition entity in 2006 the consulting firm Gordon Brothers was also involved as a minority investor and \$5.9 billion was paid for common stock and \$766 million for other securities and expenses.

See p. 1: <https://www.sec.gov/Archives/edgar/data/1005414/000119312507115768/d10k.htm>

For the initial debt structures see p. 6 of the 2005 SEC 10-K filing: http://getfilings.com/o0001193125-05-090701.html#toc64690_8

⁹ See pp. 20-21 of the 2005 SEC 10-K filing: http://getfilings.com/o0001193125-05-090701.html#toc64690_8

¹⁰ Net earnings of \$252 million for 2004 became a net loss of \$384 million for 2005, but a return to net earnings based on engineering for some years thereafter.

¹¹ Private equity have 'SWAT teams' which provide advice on rationalising operational systems (e.g. KKR's Capstone). By 2016 40% of Toys R Us sales were categorized as e-commerce mainly a substitution. Covert (2018) reports worker's experiences of eroded terms and conditions.

¹² These collate as:

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Interest expenses (US\$ millions)	503	419	403	440	514	432	464	517	447	426	455

See for example p. 25:

<https://www.sec.gov/Archives/edgar/data/1005414/000100541417000011/tru201610k.htm>

Note: it is not clear who these payments are to; given the corporate structuring potential some of this could be effectively transfers and flows within complex corporate structuring.

¹³ And it was reported the UK entity waived £584.5 million it was owed by another Toys R Us entity.

¹⁴ A CVA is an insolvency arrangement intended to allow firms to streamline and avoid going into administration or full bankruptcy with more catastrophic job losses. Creditors vote on the CVA, which requires 75% approval to proceed.

¹⁵ The investment was eventually written down to zero by the funds, creating a tax write-off potential that would partially protect the internal rate of return in terms of accounting for the fund; still, more than \$200 million in fees were charged to the acquisition over the duration.

¹⁶ In April 2019 lenders committed to convert £100 million of debt to equity and in May 2019 22 stores were closed as part of a CVA. The agreement facilitated new funding lines from debt-distress funds. Given the usual practices of these funds Debenhams future is not secure. As of early 2020 Debenhams was still carrying a reported £720 million in debt.

¹⁷ For corollary problems (see Baker & Wigan 2017; Morgan 2015, 2016, 2017; Morgan and Sheehan 2015).