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Where the Vulture Funds Nest in Brexit Britain

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The UK economy has seen a spike in corporate insolvencies, particularly in the retail, manufacturing and travel sectors since the EU referendum, and the heavy debt burden imposed by private equity has often been a factor. Vulture funds are now circling in search of freshly weakened targets, soon there will be plenty to choose from.

Vulture funds work a bit like this. A vulture fund is a hedge fund, private equity fund or distressed debt fund, that invests in debt considered to be very weak or in default, known as distressed securities.

They profit by buying up troubled firms, pile on substantial new debt, fiddle with the balance sheets, then restructure and sell the relaunched entity as if it's in good health. Private equity firms regularly benefit from tax breaks and are often based offshore – and it's this bit that is important. They contribute next to nothing to economies, very often seeing the result of collapses falling into the laps of government. If not, many employees are left without work and end up on welfare.

Thomas Cook is a good example. It was in trouble 10 years ago, but successive financial restructures by 'intermediaries' such as private equity firms, has seen a debt spike being handled like some sort of overly stuffed pass-the-parcel. After several acquisitions and loading of debt – the company was weighed down with £3.1 billion around its neck. In its last 12 months, the company needed to sell three million holidays a year just to cover interest payments (not the capital).

And another 900 million pound restructuring plan wasn't enough to save the 178-year-old travel industry icon from bankruptcy. At the last minute, the firm's bankers demanded an extra 200 million pounds in funding to pre-pay for next year's package holidays.

Wash, rinse, repeat

The same happened to another of Britain's best-known high street brands, Debenhams. It announced in April the largest loss in its 206-year history, a pre-tax loss of 491 million pounds. From there it entered a Corporate Voluntary Arrangement (CVA) which allows firms to continue trading while restructuring and now has well over £1 billion in restructured debt. Profits are sucked into debt interest payments, very often requiring more loans to pay for the shortfall.

Fellow department store House of Fraser entered a CVA in May 2018 after struggling to rid itself of a debt pile worth 1 billion pounds which had built up since a private equity purchase in 2006.

Music and film retailer HMV went into administration for the second time in six years. Again, private equity firms were implicated in the downfall of the 98-year-old brand.

Another excellent example is luxury British carmaker Aston Martin, which confirmed it will pay 12% interest on an extra £120m of borrowings. If orders for its new DBX model don't hit targets in 2020, the firm's interest rate could spike to 15% as part of its financial restructuring package. The intermediaries make the money and walk – the company is left to the risk.

Don't forget, these companies can take advantage of record long-term low-interest rates.

How bad is it overall? According to the Luxembourg-based Link Asset Services, total corporate debt in the UK climbed to record levels in 2019, hitting £638.3 billion, following eight consecutive years of rises.

Nest of vultures

Over to Ireland and focusing on a nest of just 15 Irish subsidiaries of global vulture funds where it was found that they pay just €250 a year in tax. This is despite the companies having in their control €10.3 billion worth of loans and debt located in Ireland, where in total, the 15 companies have paid just €8,000 in tax between them in a year. It is estimated that the loss to the Irish Exchequer is up to €500 million in just two years.

The analysis comes from the UCD School of Social Policy two years ago.

In another study at the same time, 24 Irish subsidiaries of so-called vulture funds had paid less than €20,000 in corporation tax over the previous two years.

This is despite the companies controlling almost €20 billion in distressed assets.

That analysis found that the 24 companies, as well as their Irish subsidiaries, will be able to make profits of 33% to 50% on their initial investment.

Circling

From Jonathan Compton – Money Week: "*Since Brexit, UK economic growth has been sub-par, moving from being nearly the best among the larger economies to becoming one of the worst*." Compton reminds us why the vultures are circling. Britain was badly affected by the global financial crisis but was still suffering when Brexit came along. It continues to suffers from:

- growth in wages outside the top 20% of earners is weak – real take-home pay for these workers remains below the 2009 level
- a steady slowdown in car sales, new mortgage approvals and big-ticket items (items not affected by internet sales)
- growth in consumer credit has waned noticeably since 2016
- personal savings are near their lowest level since 1968
- capital expenditure and business confidence are flatlining.
- profit margins are being squeezed

> "Until 2015 the UK ranked third in the world both in terms of the total stock and of net FDI investment inflows. The gross stock, at over $2trn, is enormous

> and, relative to GDP, far higher than the two global leaders, the EU and US. In terms of inflows, net annual FDI has also been gigantic, beaten only by the world's two economic superpowers, China and the US. This foreign appetite for British assets has been the key factor in allowing us to live a lifestyle that we could not otherwise afford. Until 1995, FDI was relatively minor at 1%-2% of GDP. Since then it has soared, often to 4%-8% of GDP. The UK is a world favourite for well-known reasons: an impartial legal system, good contractual laws and property rights, and relatively mild bureaucracy. You may not like Russian hoods buying top properties or Kraft taking over a "national jewel" in Cadbury Schweppes, but foreign investors have been the economic paymasters for nearly a generation. Yet since 2016, these flows have abated dramatically – hence the feeble growth numbers. In the UK equity markets, the outflows have continued – hence the relative underperformance."

The more savvy foreign investors clearly sense opportunity in our under-performing market, currency and government, and are moving fast. Approaches, bids or break-up threats have been made recently to well-known (listed) index giants. The trend is rising. The Vultures are circling looking for weakened companies to pick off. After Christmas this year, there will be a feast waiting for them for two reasons. Many struggling companies die after the December spending spree and then we have this December's election. If Boris Johnson is elected with a workable majority – the currency will plummet and confidence will drain as he pushed his version of Brexit. If Corbyn is elected – it's another year of uncertainty, even if the outcome is better. Either way, government debt will soar – from there, its anyone's guess – but the vultures will still be flying in from Ireland looking for easy prey.

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