

Fuelling Controversy: Morrisons' Asset Shuffle and the High-Octane World of Private Equity

Introduction

Wm Morrisons, the fifth largest supermarket chain in the United Kingdom, is pushing ahead with their plan to sell its fuel forecourts business to Motor Fuel Group (MFG), the largest independent forecourt operator in the UK, for up to £2.5bn. Both firms are controlled and owned by Private Equity firm Clayton Dubilier & Rice (CD&R). This will help the groceries firm pay down part of its £6.6bn debt pile it has accumulated after it was acquired by CD&R in 2021. Interestingly, this is not the first time this company has sold some of its assets to raise funds. In December 2021, seven warehouses were sold, which are currently being leased back, along with rumors about the possible sale of some of its supermarkets. If the deal were to be completed, MFG would acquire 340 stations, as well as 500 plots of land where electric vehicle (EV) charging hubs could be set up, which strongly aligns with the current objectives of the company, which has been investing heavily in an ultra-fast electric vehicle charging network. Some analysts have pointed out that this mirrors a similar transaction between Asda and the EG group, both owned by TDR Capital and the Issa brothers, where the EG group sold the bulk of their UK and Ireland forecourts business to Asda for £2.3bn. This raised some questions about how the transaction was structured and the financial engineering behind this acquisition, addressed in [this article](#) from April.

Private equity investors have different strategies that allow them to achieve their desired outcome of their portfolio companies. Among the most famous strategies are financial engineering and operational improvement. Financial engineering can involve sale-leasebacks, where assets are sold and then leased back into perpetuity, or the use of leverage to multiply the rate of return on an investment, whilst operational improvements refers to the expertise the General Partners (GPs) bring to the companies through increasing and tightening the managerial control of corporate spending, initiating cost-reduction programs, add-on acquisitions, core competencies in specific industry, and synergies with other portfolio companies. Currently, 48% of returns are generated by operational improvements, as investors have become more specialized over time. Moreover, financial engineering used to dominate the financial industry, but following the Great Financial Crisis, many of its mechanisms are seen with distrust. Regarding private equity's use of financial engineering, critics argue that transactions that involving heavy financial engineered products introduce a substantial debt burden on the target companies, increasing their default risks. This is particularly appealing to investors as their liability is limited to their stake in the company, meaning that what they stand to lose is capped. Through an operation like this, they increase the upside on their investment, accepting a higher risk, while limiting their downside exposure. Moreover, it also comes with tax benefits. Taxable profits are calculated on the basis of the surplus that remains after paying for interests. Hence, if a company is paying interests to a subsidiary located elsewhere, only the after-interest profit will be taxed. Nonetheless, this sort of freedom, which entitles higher risks for the companies, create some problems as the bankruptcy of an essential service company, such as banks (Great Financial Crisis), affects the entire economy.

CD&R's troublesome acquisition of Morrisons

Founded almost fifty years ago in New York, Clayton, Dubilier & Rice is one of the oldest and largest pure play private equity firms. It actively manages around \$60bn, invested in a broad range of industries, and raised more than \$20bn in its latest flagship buyout pool. CD&R has set itself apart from most other PE funds by developing an in-house operations team that enables it to take an active approach towards operational value creation. This means that CD&R is more than just a financial partner: it identifies and vets opportunities, sits on investment committees, reviews investments, offers strategic guidance and gets involved in day-to-day operations. In fact, according to the research paper "The value of in-house operations teams in private equity firms" published by

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INSEAD in 2009, CD&R pioneered the financial partner/operating partner model, in which every deal team includes a financial partner, with a background in investment banking or private equity, and an operating partner, with a background in consulting or large corporations. While the financial partner leads the negotiations, the operating partner focuses on the business model and finds ways of improving the business over time.

In late 2021, CD&R acquired Morrisons – the UK’s fourth largest supermarket – in what appears to be its attempt to take part in a larger trend in which American PE firms have been acquiring English firms whose valuations were slashed by Brexit and never really recovered. Founded in 1899, Morrisons had been listed on the London Stock Exchange for 54 years before being taken private by CD&R. Until 2004, Morrisons stores were primarily found in the North of England but, with the takeover of Safeway that year, the company's presence increased significantly in the South of England, Wales and Scotland. As of 2021, the company had 497 supermarkets across the UK. CD&R’s acquisition of Morrisons was arduous: it had to fight a four-month long takeover battle against a consortium led by their rival Fortress Investment Group, another investment management firm. CD&R’s final bid of 287 pence per share was only 1 penny higher than Fortress’, and 25% higher than its original offer (230 pence per share). It represented a 61% premium on Morrisons’ closing price before the offer period began and valued Morrisons’ share capital at about £7.1bn on a fully diluted basis and implied an enterprise value of £9.8bn.

As part of the leveraged buyout, Morrisons’ net debt obligations almost doubled from £3.2bn to almost £6bn – this came in the form of £2bn in term loans from banks, a £1bn revolving credit facility and £3bn in bonds. Relative to profits, this is higher than the debt taken on by the billionaire Issa brothers and private equity firm TDR when they acquired Asda, the UK’s third-largest supermarket. Moreover, CD&R had to push back its financing plan to 2022, as bond market investors grew increasingly nervous about the potential impact of the Omicron variant of coronavirus. Due to the rate hikes between underwriting and selling the debt, Morrisons’ 16 underwriters, with Goldman Sachs being the biggest, suffered more than £200m in gross losses on selling the debt, according to the Financial Times, and marking the remaining unsold debt to market amounts to another £400m in losses. And from that point on, everything that could go wrong went wrong: Morrisons’ new backers found themselves caught between rising interest rates (the annual interest bill shot up by £100m), falling property values, sticky inflation, rising wages and a falling market share (from 4th to 5th in the UK). These problems were exacerbated by the supermarket industry’s thin margins and large fixed costs since high operating leverage implies that when revenues decrease, costs decrease by much less, resulting in a larger loss. During its first full year in private-equity ownership, Morrisons slumped to a £1.5bn loss.

Already in late 2021 many analysts expected that Morrisons would be forced to sell assets – such as stores and food production assets - to reduce its leverage if things went south. Since then, CD&R has come to the same conclusion and is selling between \$0.6bn and \$1bn worth of assets to deleverage. This ties in with the Competition and Markets Authority (CMA)’s concerns over CD&R owning more than 1,200 of the 8,000 petrol stations in the UK through Morrisons (335 forecourts) and Motor Fuel Group (900 forecourts).

Latest developments: Morrison’s Divestment of Petrol Forecourts

News on the talks between Morrisons and MFG comes months after Clayton Dubilier & Rice called a halt on the potential sale of MFG. At the beginning of 2022, MFG, which operates over 900 sites in the UK, asked Investment Banks to pitch a mandate for the sale of the company. Morrison has expressed their complete interest in selling their forecourts business, even after the UK government announced to delay a ban on new petrol and diesel cars by five years.

If the current talks between the two firms owned by CD&R are positive, and the deal goes through, both parties would have benefits, as it is being negotiated in a proactive position, and neither would face refinancing deadlines

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until 2027. Both sides are keen to position the agreement as a commercial tie-up, as it will allow both companies to be active in their core business. On one hand, the forecourts being operated by FMG, one of the leading operators in the UK, while the supermarket chain focusing on food making and retailing. Moreover, this would allow each respective business to invest in their primary activities, fueling further growth. Currently, MFG has committed to invest £400m over the next 10 years into building ultra-rapid EV hubs across their existing forecourt network. This creates perfect synergies as the potential deal is said to include 500 freehold plots of land to add EV charging spaces. Hence it will further contribute to MFG's target to expand their ultra-fast electric vehicle charging network. Furthermore, customers would benefit significantly as they would get a better value proposition when fueling their vehicles because of MFG's increased market power, that would allow them to exploit economies of scale by negotiating lower prices when making bulk fuel purchases. Overall, the deal will be beneficial for both parties as it will allow them to concentrate in their core business, as well as grow as a result of the transaction.

Moreover, the transaction would also be highly beneficial to the parties because of its structure. Morrison has been under financial pressure following the debt-fueled £9.8bn takeover by CD&R in 2021. Credit rating agencies changed the outlook of the companies' ability to repay its debt from "stable" to "negative". To raise funds to repay its debt, the company sold, and then leased back, seven warehouses in December 2021, and there were further rumors of divestitures in its core business. However, this is prejudicial for the company as costs could possibly increase as the company could be tied up into extensive property deals, and ultimately collapse, as Debenham's did in 2020. On the other hand, both firms would possibly benefit from CD&R's proven operational improvement expertise to help them cut costs, and consequently improve profitability and margins.

Standing out among its competitors, CD&R is known for its impressive senior employees with previous experience in corporations as GE [GE: NYSE], Unilever [ULVR: LON], or Gap [GPS: NYSE], who are later deployed to oversee the fund's portfolio companies. Thanks to their vast managerial experience, along with the financial knowledge and capacity the firm also brings, it can provide a more thorough service to its portfolio companies, leading them to higher growth rates and better margins.

Analysts have commented that, if completed, this deal would mirror the 2021 transaction between the Issa brothers, private equity fund TDR Capital, ASDA - another UK supermarket chain - and EG group. Out of relative obscurity, they acquired ASDA, a company with an enterprise value of £6.8bn. Through the usage of a complex chain of asset sales and debt deals, which funded the bulk of the buyout, the new owners just had to put 12% of the purchase price. The acquirers were able to pay such a small portion of the purchase price as EG's parent company, Optima Bidco Jersey, also owned by the Issa brothers and TDR Capital, loaned more than half a billion pounds to ASDA's parent company, Bellis Topco, also owned by the Issa brothers and TDR Capital. To raise money for the loan, in 2020 Optima Bidco sold two batches of preferred shares, with no voting rights and that pay a fix dividend, worth £405m and £316m. Nonetheless, the unsecured loan created financial struggles for EG, which already had £8bn of debt, much due for refinancing in 2025. The loan has a 12% interest rate, with no fixed day for repayment, while Optima's preferential shares are becoming more costly. Initially they paid an 8% annual coupon, which is set to rise to 10% this year, and 12% next. Consequently, because of the financial burden that this structure is causing the company, in March 2023 it announced its commitment to significantly delever and put in place a more sustainable capital structure. Historically, TDR's business model involving substantial financial engineer through under-equitizing firms, and then pulling their initial investments through dividend recaps has allowed them for large upsides with a small risk to their equity.

Sale-leasebacks to save an investment

Asset divestments from private equity backed portfolio companies to pay down debt or even return money to the sponsors is not a new phenomenon. Apollo [APOS: NYSE] are perhaps one of the most infamous investors for

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employing this nifty piece of financial engineering. One of the most notorious examples of this was the buyout of the Casino Operator Harrah's by Apollo and TPG Capital [TPG: NASDAQ] in 2006 for \$27.8bn, funded with roughly \$16bn of debt. The heavy debt load and declining gambling revenue post-2008 ended up pushing the company and all its subsidiaries into bankruptcy by 2015, but not before the private equity owners had methodically siphoned assets to other entities they owned. Between 2011 and 2014, Caesars, at the behest of Apollo, began selling off portions of its intellectual property and Las Vegas properties including Planet Hollywood, Bally's and the Cromwell, to entities controlled by none other than Apollo and TPG. The billions in proceeds from asset sales prolonged Caesars' downfall, but creditors of the main Caesars operating company perceived the parade of asset sales not as life-saving strategies but as avaricious asset stripping: a "Good Caesars" had been established that had seized the best properties on behalf of Apollo and TPG, leaving the loan and bondholders with the weakest properties that could not pay off debts. Lawsuits began in 2014 over the asset sales and accompanying termination of bond agreements, forcing Caesars to fight a war on two fronts – contest the litigation whilst also working to negotiate a restructuring agreement with the creditors. Ultimately, Richard Davis, an independent examiner, concluded that there had been as much as \$5bn worth of fraudulent transfers, for which the liability flowed up as far up as board members, forcing Marc Rowan and David Bonderman to provide personal financial statements. Under the restructuring agreement, the stake of the financial sponsors was slimmed from 60% to 16%, marking an embarrassing loss for these savvy investors. Perhaps the biggest takeaway from this case is that even the most sophisticated financial engineering cannot save an investment if its core business is failing.

Despite the landmark bankruptcy, restructuring and litigation that followed the buyout and asset sales of Caesars, private equity firms continue to use asset divestments in this way to their advantage. In 2021, Apollo acquired Yahoo in a \$5bn carveout from Verizon [VZ: NYSE] representing an EBITDA multiple of approximately 5. Apollo funded the deal with about \$2bn in equity with the rest coming from debt. Between signing and closing, Apollo announced a deal to sell the Japanese Yahoo trademark for \$1.6bn to a public holding company called Z Holdings [4689: TYO]. Within the first year, Apollo continued to sell other non-core assets, including domain names, IP addresses, real estate and data centres, ultimately allowing them to return the \$2bn in equity they invested in the first place and essentially own the company from then on for free. Typically, asset sales are restricted by covenants in debt agreements, or the covenants state that the proceeds must be used to pay down debt rather than be returned to shareholders. However, in this case, Apollo negotiated the debt by borrowing against the cash-flowing businesses of Yahoo – which is beneficial to lenders – but was able to leave out the non cash-generating businesses such as the advertising and technology business from the purview of the bank debt. However, these businesses still had asset value in the market, and so Apollo were able to monetise them to fund the losses in the business and payout dividends to themselves. The downside of these maneuvers is that the cost of leasing them back will decrease EBITDA and so can negatively affect the valuation at exit and consequently the IRR of the investment.

Critics of private equity investors suggest that financial sponsors bankrupt portfolio companies to their own benefit and at the expense of other liability holders. Brendan Ballou from the Department of Justice explores this argument in his latest book *“Plunder: Private Equity's Plan to Pillage America.”* Brendan looks at the Sun Capital [2134: TYO] acquisition of Friendly's, an ice-cream and diner chain started in the Great Depression. Sun Capital leverage up the company and sold almost 160 restaurant locations and continued to lease them back. Although, this made a quick profit, it saddled the firm with a new, unending liability. Ultimately, the firm was pushed into bankruptcy, which Sun Capital was able to direct very skillfully. They steered the bankruptcy case to Delaware by setting up multiple subsidiaries there, a common tactic in bankruptcy considering the favourable laws towards corporations. The lawyers then petitioned to expedite the sale through a “363 sale”, where assets or a company is auctioned off free of its former associated debts. This process typically removes the discretion of the court and gives the owners greater leeway in choosing the successor. Sun Capital then proceeded to not only become Friendly's owner, but also its biggest debt holder, with hundreds of millions of dollars in unpaid debt. Sun Capital proposed to reacquire

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the Friendly's by forgiving these debts, a tactic known as "credit bidding" This removed competition from the bidding process, as others would have to bid real money against the debts to Sun Capital, trading at a fraction of their book value. Ultimately, the auction was cancelled due to a lack of interest and Sun Capital's subsidiary was able to acquire Friendly's without a fight. As a result of the reacquisition, Sun Capital acquired the company free of all liabilities, including \$115m in pension liabilities. These debts were pushed onto the Pension Benefit Guaranty Corporation (PBGC), a government-chartered insurer that rescues underfunded pensions, and whose work was paid for by other pension funds. Sun Capital performed a similar maneuver when they pushed Marsh Supermarkets, a Midwest grocer, into bankruptcy. At the time, Marsh owed millions more to its store employees in addition to \$62 million in pension commitments to its warehouse workers. (An additional fund for company executives was kept fully financed.) Sun Capital was able to transfer Marsh's unfulfilled pension obligations to the PBGC through bankruptcy, forcing that organisation to reduce benefits for warehouse workers by 25% as a result. With the aluminum-parts producer Indalex and the generator manufacturer Powermate, Sun Capital engaged in similar "pension laundering," in the opinion of a former PBGC director. Sun Capital, on the other hand, claimed to The Washington Post in 2018 that its investment in Marsh "kept the company alive" and that the "significant" pension problems of Indalex and Powermate existed before it purchased either company. In his book, Brendan proposes a revision by Congress of the bankruptcy code and most crucially urges regulators to "pierce the corporate veil" and hold private equity owners legally responsible for the actions of their portfolio companies.

Conclusion

In conclusion, the impending sale of Wm Morrisons' fuel forecourts business to Motor Fuel Group (MFG) is a significant development in the ongoing saga of the supermarket chain's ownership under Clayton Dubilier & Rice (CD&R). This transaction, which could reach up to £2.5 billion, reflects the complex financial engineering strategies employed by private equity firms to optimize their investments while addressing substantial debt burdens. It also underscores the challenges faced by traditional retailers in a rapidly evolving market. CD&R's acquisition of Morrisons in 2021 marked a pivotal moment for the company, significantly increasing its debt load. This debt, along with various financial pressures, has led to the divestment of assets, including warehouses, and now, the fuel forecourts business. Such asset sales are not unique to Morrisons and are a common strategy among private equity investors seeking to reduce leverage and return capital to investors. The potential deal between Morrisons and MFG demonstrates the synergy that can be achieved when aligning businesses with complementary strengths. MFG's focus on forecourts and Morrisons' emphasis on food retailing create opportunities for both parties to invest in their core operations and foster growth. Furthermore, MFG's commitment to expanding its electric vehicle charging network aligns with the evolving landscape of sustainable transportation. The history of private equity firms employing asset divestments, such as Apollo's actions with Caesars and Yahoo, highlights the potential benefits and risks of these manoeuvres. While they can provide financial flexibility and returns for investors, they also pose challenges related to valuation and long-term sustainability. In light of these concerns, there is growing debate over whether regulators should hold private equity owners accountable for the actions of their portfolio companies, particularly in cases where bankruptcy and asset stripping occur to the detriment of other stakeholders.

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