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The anti-private equity rhetoric from competition regulators in the United States is fierce, with some lawyers explaining the new enforcement policy as "revolutionary" and "generating a new thread of law". On the other hand, a former Department of Justice chief has criticised the new approach because "it takes aim at an industry...rather than taking aim at the effects of the specific conduct or transaction".[1]

In this piece, we ask the same question about the UK's Competition & Markets Authority (CMA): Is it signalling a revolutionary approach? The short answer is no, but the CMA has raised some new antitrust concerns that might have legs even if these are not driven by the revolutionary zeal that seems to be brewing across the pond. The concerns shine a light on distinctive features of PE ownership: leverage and a focus on increasing short-term profitability.

Market studies and investigations

Leverage, 'too important to fail' and a one-way bet

The most developed, if still somewhat implicit, theory of concern about PE in the UK comes from a series of CMA studies into care sectors. The idea is that leverage creates a 'heads I win; tails you lose' bet for investors, often at the expense of public sector purchasers of the service. If things go well, the firms make good money; if they do not, then the leverage structure makes them so precarious that, in one way or another, they need to be bailed out by their customers.

So far, the CMA has scrutinised a few PE-rich sectors in this way. It has not gone as far as validating its concerns with leverage, so we have not seen enforcement action based on leverage concerns (at least not yet).[2] Evidence that links leverage to poor market outcomes may increase the chances of the CMA picking the sector for investigation. And once a market study is opened, leveraged firms that provide 'too important to fail' products or services will almost certainly have to justify the allocation of risk and reward created by the combination of their contracts, negotiation processes and financial structure.

'Good' and 'bad' profitability

In simplistic antitrust economics, excess profitability is a signal of market power, and market power is bad. PE-backed firms are often very profitable, therefore they must be bad. Right?

Indeed, every CMA market study and investigation includes a section on profitability, and more often than not the estimates of excess profitability find themselves in the press-release and the broader narrative. In the children's social care market study, the CMA found that only PE-backed firms had the data available for measuring profitability, and "for the largest firms, a substantial proportion of independent provision, prices and profits are materially higher than we would expect."

But profitability analysis is hard, especially for high-risk multiple-bet businesses like PE firms. The complexity of profitability analysis means its

1 For more on the US, read the FT's "US trustbusters: why Joe Biden is taking on private equity".

2 In 2017, the CMA studied the market for care homes for older people and assessed the extent to which debt levels of providers affected the sustainability of the sector; a 2021 economics working paper titled "Resilience and Competition Policy" by Andrea Coscelli, (the ex-CEO of the CMA) raised this issue; a 2021 study into children's social care also considered whether the ownership status of care providers affected the price and quality of placements given interactions with public sector procurement.

outcomes are not very predictable. Economists advising parties in a market study can sometimes be surprised (even outraged) by the way the CMA thinks about profitability. Ensuring a careful, credible and consistent narrative for the raw data from the outset of any engagement with the CMA on this topic is critical. Important framing points for this narrative include:

- Profitability can be an indicator of 'bad' market power. But it is more often a result of a firm being more efficient or positively differentiated from the other firms in the market. Understanding the drivers of your profitability compared to other firms in the industry, and why entry or repositioning by competitors doesn't erode it, is essential to mitigating the risk of high profitability being taken as an indicator of bad behaviour rather than good performance.

- The CMA calculates 'excess' profitability by comparing the profitability of a firm with the expected profitability required to cover a reasonable cost of capital. While this might work for forward-looking price-setting in stable capital-intensive regulated industries (it is bread and butter for electricity/water regulators), this analysis struggles to take account of the fact that - looking backwards - some investments exceed expectations and others fall short. Setting the profitability of an individual investment in a wider context can help the CMA become more comfortable that high levels of return are not the result of harmful exploitation of market power.

- It is notoriously difficult to determine appropriate costs and revenue. Estimates based on publicly available accounting data are often wildly inaccurate, ignoring or under-counting off-balance sheet investments and intangible assets. Pre-empting any CMA profitability analysis using internal data, and sharing it once complete with tailored explanatory notes, can help ensure accurate profitability assessments.

Merger control

Moving away from 'owner agnosticism'

A 'roll-up' involves buying several smaller or independent businesses using debt and merging them into a large group that can cut costs with economies of scale. The notion that private equity is particularly incentivised to engage in roll-ups heightens authorities' concerns. It will want to ensure a transaction is not part of a broader roll-up in the industry designed to increase concentration, decrease general competitive pressure and eventually increase prices. The CMA has seen instances of rapid roll-ups in recent years by PE so this activity will be a focus in CMA merger reviews (e.g. the CMA referred to this FT Big Read in a recent decision in the market for veterinary services). The competitive analysis of roll-ups is not unique to PE. It would also apply if the CMA investigates a transaction involving a serial non-PE acquirer. And, historically, the ownership model behind an acquirer has not driven any changes to the analysis (i.e. the CMA has normally been 'owner-agnostic'). But there are two unique aspects of PE ownership that the CMA might consider when an acquirer is PE-funded.

i. The need for short-term profitability by private equity buyers (intent on exiting in due course) might switch the pricing incentives of the firm towards less intense price competition. The change in ownership may also signal this 'softening' to other market

participants pushing up the market price overall.

By this logic, a merger of two leveraged entities may be viewed as being less detrimental to competition than PE roll-ups of independent industry players (because the businesses' primary focus — profit growth — is unchanged pre- and post-merger). But a roll-up of independent industry players into a PE group could be viewed by the CMA as turning 'good' competitors into 'bad' competitors chasing short-term profitability, shifting the whole market to higher average prices in the pursuit of profit growth over competition on the merits.

This thinking can affect the way the CMA weighs the competitive constraint from different players in a market where a merger is under review. For example, in its phase 1 decision regarding vets, the CMA highlighted the different business models, the acquisitive nature of PE and the impact of PE-led vertical integration and consolidation on the industry. It considered whether different weights should be applied to the market shares of PE-owned corporate groups of vets to reflect a less / more significant constraint.

The CMA did not ultimately decide on this question but what does this new attention to the ownership model mean for PE deals? If you're thinking about a PE deal that bolts one competitor onto another, you need to think early on about different ways the CMA might apply weights to competitors to reflect their ownership models. And plan accordingly. Otherwise, you may be in for a nasty surprise if the CMA's view of consolidation in the market suddenly looks very different from the in-house view well into a merger review process.

ii. The requirement for higher EBITDA in order to service higher debt costs created by PE funding models can also fuel price increases.

While competition should ordinarily discipline a PE buyer to keep prices low post-merger, the CMA will have stronger concerns if the merger is (i) highly leveraged; and (ii) in a too-important-to-fail sector where a 'heads I win, tails you lose' bet is likely, with associated consequences for consumers.

The CMA could conceivably raise concerns under these conditions even if the merger leaves several post-merger competitors in the market. It remains to be seen how many competitors the CMA thinks is too few under this theory: Is four competitors sufficient to discipline pricing and quality and incentivise innovation when high leverage meets too-big-to-fail? Or does the CMA need five or more to mitigate the risk to competition and consumer harm?

Understanding how ownership can influence the CMA's decision-making, and factoring this into pre-deal risk assessments can help minimise regulatory surprise from these novel theories.

So, is the CMA taking on private equity?

Private equity contributes towards that end by providing diversity and flexibility in management and investment options. As this study shows, painting PE with a broad brush ignores inherent heterogeneity. PE firms are not the baddies.

However, different business models will affect how firms operate in a market, and it is legitimate for competition authorities to take leverage and profitability into account when (i) conducting market studies; and (ii) deciding on mergers. Understanding why the CMA is interested in

profitability strategy and leverage structure and how this feeds into the decisions it makes can ensure that the competition regime does not unfairly punish an important set of participants in a functioning modern economy.

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