

# Manchester United's gearing crisis

*Nigel Watson looks at how the Glazer takeover has affected Manchester United's gearing ratio*

In May 2005, American businessman Malcolm Glazer completed his takeover of Manchester United by purchasing £800 m worth of shares in the football club. The takeover is an excellent example of a levered takeover: the majority of the money needed by Glazer to buy the shares was borrowed. As the new owner of Manchester United, Glazer took the club off the stock market, converting the business from a public limited company to a private limited company. The loans taken out by Glazer to finance his takeover were then transferred over to Manchester United's balance sheet. Many Manchester United supporters were outraged. For many years the club had been virtually debt free. However, due to Glazer's leveraged takeover, the club was now saddled with huge debts that would need to be serviced for many years to come. Manchester United's gearing ratio had soared.

## What is gearing?

Gearing is an accounting ratio that measures the degree to which a firm is dependent upon borrowed money.

In business, long-term capital can come from three places:

- loans
- shares
- reserves (past re-invested profits)

Together, these three sources of long-term finance make up a firm's capital employed. In companies that are highly geared, loans form a very high percentage of the firm's capital employed. The formula used to calculate gearing is shown below:

$$\text{gearing ratio} = \frac{\text{loan capital}}{\text{capital employed}} \times 100$$

**Manchester United's gearing**  
Prior to the takeover in 2004, Manchester United's capital employed was £238.8 m, loans making up just £8.8 m of this total. This meant that the club's gearing ratio was:

$$\frac{\text{£8.8m}}{\text{£238.8m}} \times 100 = 3.7\%$$

This was a very low figure. A gearing ratio of 3.7% means that for every pound in the business, less than 4p had come from loans. The Glazer takeover increased gearing because the deal swapped £800 m of share capital for £800 m of loan capital.

As a result, gearing rose sharply. It is no longer possible to calculate Manchester United's gearing ratio with any degree of precision because the Glazers have set up a plethora of subsidiary companies that are linked to the football club (see Figure 1), the aim being to hide debts off the balance sheet. In 2009 Glazer tried to refinance his loans at lower rates. The prospectus used to

drum up support claimed that Manchester United's loans were just £510 m, compared to the club's capital employed of £448 m. On the basis of these figures Manchester United's gearing ratio in 2009 stood at:

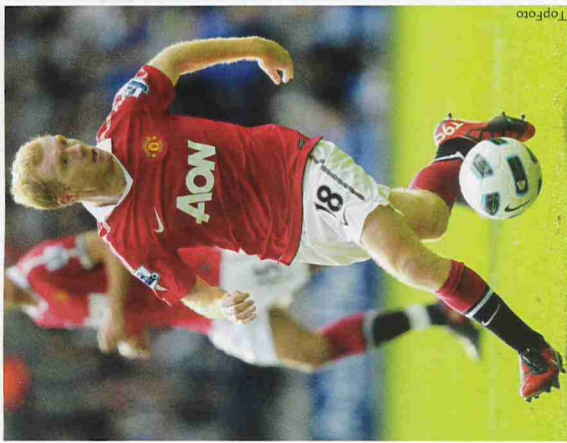
$$\frac{\text{£510m}}{\text{£448m}} \times 100 = 114\%$$

## Advantages of high gearing

Some firms decide to borrow additional loan capital, and increase their gearing, for positive business reasons.

## Rapid expansion

The firm concerned might want to expand quickly to seize an opportunity that it has spotted. Gaps in the market do not tend to last too long because competitors are likely to be looking for similar opportunities. If a firm is slow to react to a gap in the market the opportunity might be gone by the time the firm is ready to go ahead with its expansion. Launching a new product is usually very expensive. Some firms might be apprehensive about raising the additional cash by selling shares due to the ownership issues. Other firms might try to raise the cash they need by accumulating cash from past profits. However, this can take too long, resulting in the loss of the early advantage. In these circumstances increasing gearing looks like an attractive option.



With less money to spend on high-profile transfers, Manchester United are relying on older players like Paul Scholes

- Total interest paid: 5% of 230,000 = £11,500
  - New profit after all costs: £76,200
- In this case increasing gearing has been a smart move. Profit has nearly doubled in just 1 year. This would not have been possible without the decision to take on debt and increase gearing.

### Drawbacks of high gearing

Unfortunately for the fans, the increase in gearing at Manchester United has not been used to build a new stadium or to invest in new players. The £800 m borrowed by the Glazers was instead spent on acquiring shares from existing shareholders, thereby going straight into the pockets of former shareholders, such as J.P. McManus and John Magnier, who sold out to Glazer.

### Higher fixed costs

Banks are not charities. In exchange for loans, banks charge borrowers interest. The amount of interest paid by a firm depends upon two factors: the total amount owed, and the interest rate charged on the debt. Banks tend to charge different rates of interest to different borrowers. Borrowers that are considered to be less risky tend to pay much lower rates of interest than borrowers who are considered by the bank to be a greater credit risk.

High interest costs created by the Glazer takeover appear to be crippling Manchester United. According to an article written in October 2010 by BBC journalist David Bond, Rochdale Rovers might easily suffer from a

since the takeover the club has paid more than £450 m in interest payments. The banks are also charging Glazer very high rates of interest. For example, the hedge funds that lent Glazer £220 m in unsecured payment in kind (PIK) loans attract, on average, an annual interest rate of 16%. Last year the club paid over £80 m in interest payments, which was more than the club received from the sale of Cristiano Ronaldo to Real Madrid. The money spent on servicing the debt created by Glazer could have been used by Alex Ferguson to buy new players.

Loan interest is an example of a fixed cost — a cost that does not change in line with output. Unlike dividends, interest on loans has to be paid back even if the firm that has borrowed the money is not turning a profit. Highly geared firms like Manchester United are vulnerable to an increase in interest rates that would send their interest charges, and therefore their fixed costs, rocketing.

### Gearing can magnify losses

During recessions, when trading conditions are tough, high gearing will tend to magnify losses. There are two reasons for this:

- First, bigger loans mean higher interest charges.
- Second, the decision to increase gearing means that there is now more money in the business to lose during periods when return on capital turns negative.

For example, during a recession, or a poor run of form on the pitch, small clubs like Rochdale Rovers might easily suffer from a

Table 1 Manchester United's balance sheet

	2007	2008	2009
(£ thousands)			
Fixed assets			
Intangible assets — goodwill	451,489	421,453	386,065
Intangible assets — players' registrations	123,091	92,739	110,858
Tangible assets	251,958	260,784	253,206
Investments	281	—	—
Current assets — other	826,819	774,976	741,128
Cash at bank and in hand	253,255	273,803	297,332
Creditors — amounts falling due within 1 year	62,129	49,745	146,583
Net current assets	(82,009)	(72,494)	(82,829)
Net current assets	233,375	251,054	343,360
Total assets less current liabilities	1,060,194	1,026,030	1,102,214
Creditors — amounts falling due after 1 year	(530,365)	(519,779)	(509,883)
Net non-current assets — other	(70,532)	(74,110)	(130,796)
Net assets	459,297	432,141	447,846
Total shareholders' funds	459,297	435,002	450,749
Minority interests	—	(2,861)	(2,903)
Capital employed	459,297	432,141	455,507

Source: <http://i.dailymail.co.uk/pdf/ManUtdProspectus.pdf>

drop in match-day ticket income that sends ROC into negative territory. If the club had stayed small and operated with just their old facilities the total trading loss would have been greatly reduced. For example, assuming a ROC of -30% and a capital employed of £238,500, the club would have made a loss of £71,550. However, by expanding on the back of borrowed money, capital employed has risen to £438,000. With the second stand open, the total loss for the business is £438,000 × -30% = -£131,400. The business might have been able to stand a 1-year loss of £71,400. However, by gearing up the club's chance of surviving the recession will have been greatly reduced.

The fans' other main grievance with the Glazers relates to the quality of the first-team squad. Star players, such as Ryan Giggs, Gary Neville and Paul Scholes are beginning to fade as they approach retirement, but adequate replacements have

### The fans fight back

On the pitch, Manchester United has been fairly successful since the Glazer takeover. Manager Alex Ferguson has steered the club to glory in the 2008 Champions League, beating arch-rivals Chelsea in the Moscow final. United also won three back-to-back Premier League titles from 2006-07 to 2008-09, leaving the club just one championship short of Liverpool's all-time total. Under the Glazers, Manchester United has evolved into a formidable revenue generating machine. The club's turnover has more than trebled since the takeover. Costs have also been cut too, especially the back office payroll.

Despite these successes, Malcolm Glazer and his sons are very unpopular with the



Fans burn an effigy of Malcolm Glazer outside Old Trafford

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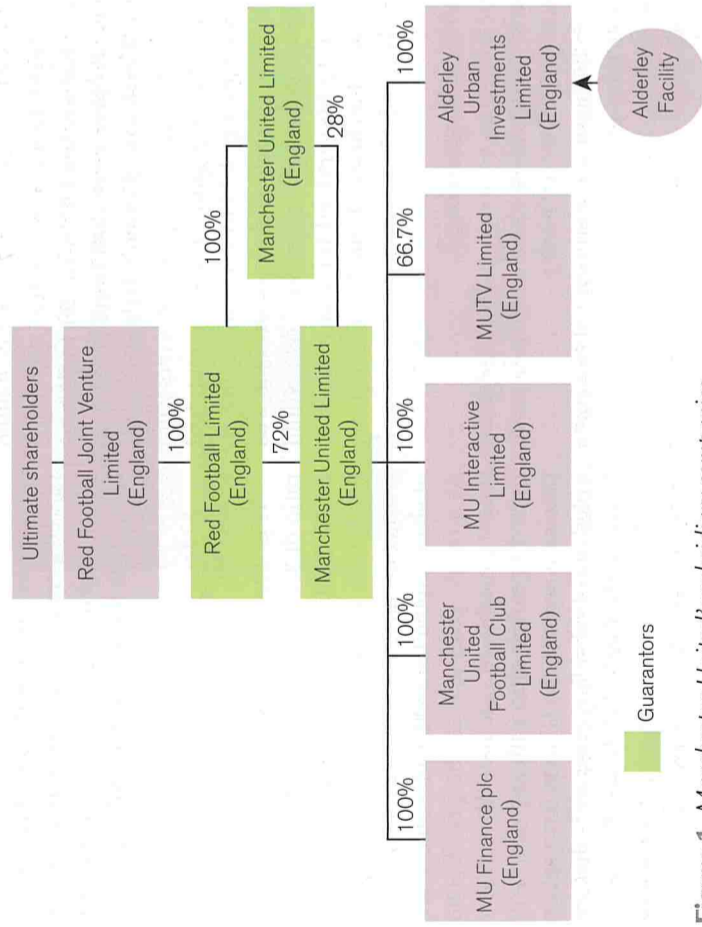


Figure 1 Manchester United's subsidiary companies

### High gearing magnifies profits

Gearing enables an owner to produce higher profits from an enlarged business. During economic booms it might make sense to increase gearing. If the company's return on capital is greater than the rate of interest paid on the firm's loans, total profit will increase as gearing increases.

The following example shows how high gearing can magnify profits. Under the commercial directorship of Roger Raymond, Rochdale Rovers currently achieves an ROC of 20%. The capital employed of the business is £200,000 and the business has loan capital of £30,000.

- Current gearing = 15% (£30,000 / £200,000 × 100)
- Profit before interest charges: £40,000 (20% of the capital employed)
- Assuming an interest rate of 5%, the firm's total interest cost would be £1,500
- Profit after interest costs: £40,000 - £1,500 = £38,500

The owners now decide to open up a new stand that will double capacity and cost £200,000. The money needed will be raised from a bank loan. During the first year the new stand is full every week. The business continues to enjoy a return on capital of 20%:

- New capital employed: £200,000 + £38,500 + £200,000 = £438,500
- New loan capital: £30,000 + £200,000 = £230,000

- New gearing: 230,000 / 438,500 × 100 = 52.4%
- New profit before interest: 20% of £438,500 = £87,700