Global Themes

Over the past year, we have frequently mentioned liquidity as one of the key global themes we monitor as part of our investment process. While we have devoted previous columns to examining the origins of this "global liquidity glut", we would now like to take a closer look at one of its prime beneficiaries – private equity funds, and the effect this burgeoning industry is having on the public equity markets, and on shareholders of public equities in particular. While the industry is riding a wave of unprecedented positive press coverage stemming from the rash of record breaking deals announced in the last six months, the effects these deals are having public equity ownership are not so positive.

In this installment, we will discuss some of the less obvious (but increasingly concerning) effects private equity is having on public company valuations, as well as the conflicted role management can sometimes play in facilitating such transactions. Lastly, we will examine whether instilling fiscal discipline, one of the frequently touted benefits of private equity, can be achieved only through this type of transaction.

Ever since the RJR-Nabisco deal etched private equity into the wall street lexicon, the industry has grown in stature and prominence. Driven in large part by the acceptance of "alternative investments" as a separate asset class by institutional investors searching for higher yields and an "uncorrelated" asset class to complement their public equity holdings, private equity has more recently benefited from the confluence of low interest rates and lax credit from banks awash with excess cash.

In fact, private equity's influence on the markets is only likely to grow over the next several years, as they begin to put their exceptional war chests to work. According to the Financial Times, the backlog of buyout funds as of the end of 2006 was roughly $300 billion. If we assume 80% of all private equity deals are debt-financed, that means there is approximately $1.5 trillion in potential "dry powder" for private equity deals. To put this in perspective, this represents roughly 12% of the S&P 500's market capitalization. Moreover, because of the use of debt (leverage), private equity firms are often able to offer takeout premiums (to public shareholders) in excess of what other public companies would be willing or able to pay for the same acquisition.

So what's the problem? From a shareholder's perspective, there are several issues.

Lower Valuations

One of the main issues is the trend towards lower valuations. Figures compiled by Thomson Financial suggest that the average private equity takeover premium has decreased from 44% in 2000 to 29% in 2006. At first glance, this may seem rather counterintuitive, since competition (among private equity funds) has dramatically increased over the last five years. In fact, many of these funds are now pooling their resources to go after larger acquisitions. While collusion amongst these firms is hard to prove, the Justice Department has begun investigating several recent high profile deals for just that reason.

However, the trend towards lower valuations can also be partly explained by timing. While the premium paid may compensate investors for future cash flows out 6-12 months, it does not compensate for the potential gain over the next 5+ years. In his annual letter to shareholders, Warren Buffet warned that "private equity firms are 'deal flippers' that use financial engineering to eke out quick gains rather than nurturing companies for the long term." Buffett is not alone in sounding the alarm and calling for change. The recently announced deal to take Clear Channel Communications (CCU) private has received heavy resistance from the company's top two investors, Fidelity Investments and Highfields Capital, both of whom feel that the current (as of March 31, 2007) offer of $37.60 per share is

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The Typical Private Equity Investment Cycle

Not all companies make attractive takeover candidates. Private equity firms are quite selective about their takeover candidates, preferring companies with low debt levels (i.e., high capacity for incremental debt), high cash flow generation (to service any additional debt), and meaningful cash on the balance sheet. In a leveraged buyout (LBO) transaction, a private equity fund will usually issue bonds or take on bank loans to finance the takeover of a target firm. In most cases, 70%-90% of the transaction is financed with debt, with the debt often collateralized by the assets of the target firm. By introducing leverage (debt) into the equation, these firms are forced to "wring out the inefficiencies" and cut expenses in order to shore up cash flow to service the additional debt load. The holding period for this type of investment is 4-5 years, depending on the market conditions and industry sentiment. The exit strategy for most involves either a sale to another company or an initial public offering (IPO). Assuming market conditions are amenable and the appropriate exit strategy is executed, these transactions can produce proceeds far above the initial purchase price, resulting in attractive returns for investors in these private equity funds. ■

Trend Toward Bigger Deals Continues

Eight of the ten largest private equity deals ever were announced in the last 12 months

Company	Year	Deal Size[1]
TXU	2007	$45.0
Equity Office Properties	2007	$38.9
Hospital Corp of America	2006	$32.7
RJR Nabisco	1989	$31.1
Harrah's Entertainment[2]	2006	$27.4
Clear Channel Communications[2]	2006	$25.7
Kinder Morgan[2]	2006	$27.4
Freescale Semiconductor	2006	$17.6
Albertson's	2006	$17.4
Hertz	2005	$15.0

[1] *In billions; values include assumed debt* [2] *Pending Transactions Source: Fortune*

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too low. They were joined recently by influential advisory firms Institutional Investor Services (ISS) and Glass-Lewis, who advised clients to vote against the deal unless the premium is increased. In this particular case (and many others), management can sometimes cloud the issue by strongly endorsing the deal, even if it is not in the best interest of shareholders.

Conflict of Interest

To understand why management would endorse such a deal, keep in mind that executives of target companies are frequently offered lucrative payout packages and/or equity positions in the private company contingent upon the consummation of a proposed deal. A wrinkle in the private equity buyout process makes it easier for managements to push a deal through than with an open tender, exacerbating the conflict of interest. Keep in mind that in an open tender, each investor is given a vote whether to accept the bid. In a buyout, a special committee appointed by directors (usually made up of corporate insiders) makes the decision to sell, with the tentative agreement voted on by shareholders. In other words, the decision to sell is actually made by a small group of people chosen by the board. Shareholders are only asked to vote on the resulting agreement. While shareholders may reject the takeout price and vote against it, it will have a muted effect unless organized investor groups with large blocks of shares are actively involved in the negotiation process (as evidenced above).

While this may work in increasing the premium, it misses a more important point – why can't shareholders make management undertake the same streamlining and profitability-enhancing changes they are likely to undertake under a privately held company?

Loss of Talent

One of the primary benefits frequently cited by private equity types is the fiscal discipline that high levels of debt instills in management. The argument holds that higher levels of debt forces managers to run the business more efficiently. The argument does hold some merit, but from a shareholder perspective, could publicly listed companies not create the same effect through increased debt levels in their capital structure? Possibly, but it does little to address the real problem – the loss of talent to private companies. Managers in the public arena are often paid less, deal with excessive regulation brought about by Sarbanes Oxley and face short term scrutiny by over zealous wall street analysts. Not exactly a compelling proposition.

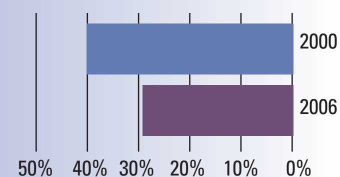
Unfortunately, this is not likely to change anytime soon. Our current regulatory environment was borne out of the Enron, Worldcom, and Tyco fiascos. While the regulation pendulum has swung far to the right (driven in large part by public pressure), private equity has stepped into the vacuum and staked out a "middle ground" where regulation is relatively non-existent, corporate talent is easily lured away, and excess profits are easily obtained. In fact, widespread belief in the sustainability of this model has caused many in the public markets to be quite lax about the true risks posed by the private equity machine.

Underestimation of Risk

The "Greenspan put" of the late 90's, whereby equity markets were propped up in tough times by the monetary actions of former Fed Chairman Alan Greenspan, has recently been replaced by the "private equity put" – a belief that private equity funds, as the "buyers of last resort," will step in to buy companies on any market weakness. However, this assumes that the engine of the private equity machine - cheap financing – will be unaffected and/or uncorrelated to any widespread market weakness. If recent history is any indication, this is not a particularly smart bet.

Take Out Premiums Decreasing

Private Equity Take-Out Premiums
Average % premium
of all private equity deals



Source: Thomson Financial

Given the amount of leverage employed in these deals, any misstep or large bankruptcy could easily spill over to the global markets, given the large number of creditors, banks and institutions involved in financing the debt underlying these deals. As such, we view cheap financing as the Achilles heel of the private equity industry.

Lastly, our client portfolios have benefited greatly from the rise of private equity both in terms of acquisitions of portfolio companies (Brookstone, Univision) as well as through our investment in Goldman Sachs (one of the main engines of the private equity financing machine). Our goal in discussing these trends and highlighting the relevant risks was done to share our views and concerns with you, our clients. As stewards of capital invested in the public markets, liquidity (cheap financing) will continue to be one of the key themes we monitor closely. ■