Masters of the universe

Charting record-breaking trends in 2005, private equity lawyer DAVID PATIENT asks whether the exponential rise of this type of investment is a sign of overheating or natural evolution

The European private equity market would appear to be in rude health, passing the symbolic €100 billion mark for sums invested in 2005 according to Incisive Media. From a once niche, alternative investment, where institutional investors conducted their business away from the public gaze, private equity is now in the spotlight, its influence all around us, making an important contribution to the European economy by providing finance for new businesses and technology, and re-energising existing businesses. In the UK alone, firms backed by private equity now employ almost one in five of the private sector workforce and pay nearly £30 billion in taxes.

The record-breaking year can be attributed to several factors. These include the unprecedented amounts of equity which investors have to spend (the so-called ‘wall of money’) – another €52 billion was raised by 41 European funds in 2005 according to Private Equity Intelligence (up from €16 billion by 26 funds in 2004); the relatively benign economic conditions across most of Europe, and an opportunistic investment environment with large conglomerates slimming down and continued industrial restructuring; receptive and liquid debt markets fuelled by the arrival of hedge funds as active providers of subordinated debt to the leveraged buyout market; secondary buyouts continuing to feature strongly in the European M&A arena; and favourable conditions for IPOs and higher levels of corporate M&A activity providing plentiful exit opportunities.

It is reasonable to assume that last year’s stellar performance will continue into 2006, but as private equity funds get bigger and deal size continues to grow exponentially, the question must be asked whether this is a sign of overheating, or part of the natural evolution of private equity. Whichever is the case, the industry should take note of the ‘class of 2005’ and see what lessons can be learnt.

Although private equity made a record contribution to M&A in Europe last year, the value of private equity deals as a proportion of total M&A was down on 2004 – from 25 per cent to 21 per cent of total European deal flow. What distinguished 2005 from preceding years was the return of the strategic or corporate buyer to the M&A market. While this could be construed as negative for the buyout industry because of the increased competition for deals and resulting tendency to drive up prices, on the sell-side it has its advantages. Trade buyers mean more exit possibilities for private equity investors; and in 2005 the tide clearly turned in favour of trade buyers, rather than IPOs or sales to rivals, as private equity groups attempted to swing the resurgence in corporate deal-making in their favour. As a result, while secondary buyouts still accounted for a third of sales, the value of trade sales last year was more than double the level of 2004, according to Dealogic.

On the buy-side, although continental Europe has finally started fulfilling the industry’s expectations in terms of its contribution to deal flow, the best hunting ground for European private equity firms in 2005 was to be found buying from competitors or the stock market. According to the UK’s CMBOR (Centre for Management Buyout Research) secondary buyouts and take privates (or ‘public to privates’ as they are also known) accounted for over 70 per cent of the UK market last year, for example. In contrast the value of traditional primary buyouts from UK corporates has declined dramatically over the last five years, from over 50 per cent of the market to just 13 per cent in 2005.

Evidence suggests that secondary buyouts – effectively a buyout of a buyout – perform as well as primary buyouts, but there is an understandable nervousness among limited partners that funds may find it hard to add value in this game of pass the parcel; tertiary or even quaternary buyouts are currently not unusual. As a seller, however, some of the advantages a secondary buyout has over an IPO, and which therefore makes it a more attractive exit route, are that the fund can often get a better price, can do the deal quicker and can sell 100 per cent of the business in one go. The same may apply to a sale to a trade buyer but, despite the recent resurgence of the public markets, IPOs on the other hand can entail a lot of work for an uncertain return.

One particular characteristic of a sale by a private equity owner (whether by way of secondary buyout or trade sale) is that the seller will almost certainly refuse to provide any meaningful warranty or indemnity protection (other than in relation to its title or capacity). Whereas warranty and indemnity insurance was at one time regularly used to plug this gap, experience would suggest that, in 2005, this solution was pursued less frequently – although there is expectation, as a result of lower costs, of greater use in 2006. Market practice would also indicate that warranty caps are rarely agreed at 100 per cent of consideration these days, as sellers take advantage of competition between rival bidders to get the best price from, while giving the least possible protection to, the buyer.

As previously noted, for private equity firms, selling to a rival in 2005 was less likely than to a trade buyer, and one hallmark of the competitive deal environment has been the deployment of the auction process in most mid-market and large buyout deals. This can involve a considerable amount of work for lawyers who may be negotiating with two or more buyers right up to the line. In addition, law firms often have to provide two teams to sellers, as strong public markets have meant that many institutions run an informal dual-track process on exit (whereby they test the appetite of potential buyers while simultaneously preparing for a flotation). Inevitably, at the top end of the market, it is the same funds chasing the same deals. For active private equity lawyers, it can be extremely difficult to manage both conflicts of interest – it is not unusual to be approached by two or three clients looking at the same deal – and client expectations, in circumstances where transactions are managed to tight

timetables by investment banks. And there is also the issue of costs to consider, not only for law firms which may be asked to share their client's pain on an unsuccessful bid, but for the funds themselves who may find that 'abort' costs start hitting returns. This can add pressure on private equity houses to do a deal while at the same time they are trying not to overpay, which, in the current market, where buyout groups are being offered finance on aggressive earnings multiples, is tempting.

Fears that bank lending on leveraged deals is creating 'bubble-like' conditions are very real. A survey conducted by *Financial News* and Société Générale in December 2005 concluded that 95 per cent of private equity managers believe that leverage multiples were reaching "dangerous and unsustainable levels". Buyout firms are borrowing an average of 5.5 times the target's current EBITDA – up from 4.5 times in 2004. The average enterprise value to earnings multiple of deals, including the equity component, has climbed to 8.8, higher even than the boom in the late 1990s. Hedge funds, a serious threat nowadays to the traditional pastures of private equity firms, have undoubtedly contributed to the high leverage multiples seen in buyouts over the last couple of years. As active providers of subordinated debt – for example helping finance Malcolm Glazer's highly-publicised takeover of Manchester United – they have added further liquidity to the financial markets, in turn aggravating upward pressures on prices.

To make matters worse, research published last month by the CMBOR has poured cold water on the notion that higher borrowings produce greater returns. It concluded that for deals above £100 million, high gearing is very strongly associated with lower returns and a survey of 321 private equity disposals also found that the amount of leverage on deals between £10-100 million had "no significant influence on returns".

The easy availability of cheap debt led private equity firms to borrow a record €123.5 billion to fund European buyouts in 2005, nearly twice as much as the previous year, according to Standard & Poor's. But the UK Financial Services Authority has warned that it is looking at the private equity industry to see if it poses a threat to the financial system. In particular, the regulator is concerned about the effect the private equity market may have on the efficiency of the overall capital markets, and whether the leverage and illiquidity inherent in private equity structures may increase the risks to financial instability. Borrowers are also acutely aware that if a downturn comes, because banks now sell the majority of their exposure in the secondary market, it may be difficult to know exactly who you are dealing with when an investee company breaches its banking covenants.

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The mega-deal, or '*LBO éléphant*' as it is known in France, is not new to the market, but the deals and funds keep getting bigger. In 2005 there were nine such European deals (according to Incisive Media who set the bar at €1.65 billion), up from four in 2004. Their value, however, has nearly tripled in one year, from €8.8 billion to €24.2 billion in 2005, such that they represented 21 per cent of European buyouts by value, against 11 per cent in 2004.

The increasingly mind-boggling size of deals evokes the days of the $25 billion buyout of RJR Nabisco that made KKR 'masters of the universe'. But commentators note that the private equity market is different now – sale prices are increasing as funds compete. According to Bain & Co, the result is that over the full life cycle of completed private equity deals, nearly two transactions out of five yield cash returns that fall short of their original cost.

The value of European M&A has risen to its highest level since the technology-led boom of the late 1990s and has now surpassed that of the US. But the market is ever more competitive and there is a feeling that larger buyout funds will have increasing difficulty in finding opportunities of the size they need to generate significant returns, and that in any event returns have peaked. Although it is clear that some investors do regard large private equity funds in a negative manner, the problem seems to be that investors are having difficulty finding other areas where they can deploy significant capital and, notwithstanding falling return expectations, the asset class is still attractive in relation to the bond and equity markets.

But the bulls note that private equity accounted for just 2.5 per cent of the 2005 aggregate market capitalisation in Europe, giving the industry plenty of room to grow. At the recent World Economic Forum in Davos, chief executive of Apax Partners Martin Halusa said that he could envisage the creation of a $100 billion fund within ten years. This would be ten times the size of the largest private equity funds today and if it became a reality would put many of the world's biggest companies within the grasp of private equity groups, ensuring that these 'barbarians' have the means to take over the world, if not the universe!

Highlights of 2006 may include the first €20 billion European deal, the first take private of a listed company by a hedge fund or even a successful bid for a FTSE 100 company. But there is likely to be some pain (and plenty of refinancings) too, particularly if, as many feel, debt requirements have been misjudged. ■