The place of private equity in corporate finance and mergers and acquisitions

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1. Introduction

The world has changed for private equity since summer 2007.

The global financial crisis highlighted a number of inherent flaws in the traditional buy-out model and caused a crisis of identity among private equity firms and their investment professionals. The economic downturn confirmed that, like other forms of economic behaviour, private equity is not immune from the ravages of the market and the booms and busts of the economic cycle, and does not and never did represent a risk-free form of financial alchemy. As the world emerges from the financial crisis the question facing the private equity industry is whether it has truly learnt any lessons from the downturn and what steps (if any) will it take to mitigate the use of leverage to generate its economic returns in the future.

Before the onset of the economic slowdown in 2007, private equity was at the centre of corporate finance and merger and acquisition (M&A) activity, and comprised approximately a quarter of such activity worldwide. What had been perceived in the early 2000s as an alternative asset class on the fringes of unrestrained financial capitalism had become a mainstream and accepted investment activity, attracting the best investment professionals, the highest-calibre operational managers, world-class executive managers and waves of institutional money.

At its core, and at its best, private equity still represents one of the most potent means of creating corporate value yet devised. Before the credit crunch, industry participants proclaimed a golden age for the industry and speculated that the first $100 billion buy-out could be within reach.[1] Although confidence returned to some parts of the industry with particular speed given the troughs experienced in the downturn, even a $5 billion buy-out deal is considered particularly noteworthy these days, and club deals are still infrequent and relatively unusual.

So, how did private equity rise and fall over its first 40 years, and do history and prior market corrections hold clues as to how the asset class may best mitigate its flaws during the next decade? As Mark Twain is often (erroneously) credited with observing: "History does not repeat itself but it does rhyme." Will private equity heed that advice?

1 Attributed to Carlyle co-founder David Rubenstein during early 2007.

2. The development of private equity

The growth of private equity is typically traced back to the founding of buy-out firm Kohlberg Kravis Roberts & Co (KKR) in the United States in the mid-1970s and the development of the leveraged buy-out model.[2]

However, in many ways the development of private equity is just another milestone in the growth of entrepreneurship that has been ongoing since the industrial revolution. The pursuit of profit and wealth is not a new concept, however well developed current methods of financial engineering may seem compared to earlier methods to try to get rich quick.[3]

Private equity developed in the United States for a number of reasons.[4] First, antitrust laws in the early part of the last century made it increasingly difficult for rapacious entrepreneurs to continue to exercise dominance over large parts of US society, including key sectors such as oil and steel. Second, and following the Wall Street Crash and the survival of the US economy after the Great Depression, by the 1960s it had become clear that the wave of mergers and acquisitions in corporate America could not continue and that the conglomerate was an outdated business model. The short-termism of earnings per share goals and beating analysts' expectations each quarter left many of the brightest and best corporate managers feeling unfulfilled. Third, the arrival of hostile takeovers meant that corporate norms were jettisoned in favour of a more aggressive, and unrestrained, form of economic behaviour. Fourth – and perhaps most importantly, given the importance of the leveraged buy-out model to private equity in the early years – was the rise of high-yield or 'junk' bonds from the early 1980s in the United States, at the same time as financial investors such as KKR first began to emerge.[5] In essence, junk bonds provided private equity with a highly liquid market for available debt below investment grade, meaning that larger corporations were no longer beyond the reach of private equity players or ambitious managers who saw the attractions of selling out to private equity investors and making large personal returns for themselves.

3. The leveraged buy-out model

In essence, the leveraged buy-out model involves buying a business through borrowing money from a third-party bank or other financial institution. The company's cash flows are used to make the loan repayments and, together with the company's assets, provide security to the lenders until the debt is repaid.[6]

In the early days of private equity, and indeed for the majority of today's financial sponsors, the driver for returns in the classic leveraged buy-out model was to buy the greatest amount of assets with the least amount of personal (or equity)

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2 For the definitive commentary see George P Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (Cambridge University Press, 2005).

3 For interesting accounts of the decline of the robber barons see Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (Atlantic Books, 2003) and Ron Chernow, *Titan: The Life of John D Rockefeller, Snr* (Vintage Books, 2004).

4 For more see Bruce Wasserstein, *Big Deal* (Warner Books, 1998).

5 For the definitive account of the rise of the US high-yield market and the influence of junk bonds on M&A activity from the mid-1980s, see Connie Bruck, *The Predators' Ball: The Inside Story of Drexel Burnham and the Rise of the Junk Bond Raiders* (Penguin, 1998).

6 See *Big Deal* referred to above.

investment. In short, a company's future was mortgaged in favour of being able to service debt from the company's existing cash flows. There was often little margin for error, so usually the companies that found themselves attractive to private equity firms were mature businesses enjoying leading market positions in their sectors and stable cash generation without any seasonal swings or need for high capital expenditure.

Over time, and as the private equity space became more crowded given the personal financial rewards on offer, other variants on the classic leveraged buy-out model emerged. There were 'break-up' leveraged buyouts, where asset sales were seen as the main means of repaying acquisition debt (being either traditional bank loans or junk bonds), since existing cash flows would be insufficient to service the company's debt pile, and also 'strategic' leveraged buyouts, where fragmented industries would be targeted by the private equity investors so that a number of unglamorous (sometimes loss-making) single entities could be consolidated or rolled up into a more attractive whole before being offered for sale on the public markets by way of an initial public offering.

4. The growth of buy-out firms

By the late 1980s a number of leading buy-out firms had been established in the United States. These were able to tap into the increased demand for private equity product among US state pension funds, which had been disappointed by relatively unexciting performances of their investments in the US stock and bond markets during the previous decade and which had turned instead to alternative investments such as private equity to prop up ailing returns. These twin drivers – more and more capital available for investment and more and more specialist firms prepared to invest it – meant that by 1988 there were said to be over 200 buy-out firms controlling an estimated $200 billion for acquisitions worldwide once leverage was taken into account.

5. The end of the first golden age: private equity grows up

With hindsight, KKR's $31 billion hostile takeover of the US listed foods and tobacco giant RJR Nabisco/Borden in 1989 still represents the high-water mark for private equity investing, and continues to be the single deal most associated with private equity as an asset class in the educated public's consciousness, even if the returns for KKR on that deal were considerably less than those for some of its other investments. It is worth mentioning in passing now not only for its historical significance, but also for the fact that until early 2007 it remained the largest private equity buy-out ever consummated, and before the credit crunch it symbolised the type of transaction that private equity mega-funds coveted using their ever-increasing pools of capital. Even with the re-emergence of the capital markets in the US during the past two years it is difficult to imagine exactly when the next $30 billion private equity buy-out will occur.

The heady days and hubris of the late 1980s inevitably led to a correction and more sober attitudes in the private equity industry during the following decade. To that extent, private equity's recent problems can be seen as another swing of the pendulum for those (old-fashioned) investors willing to place recent history's trials and tribulations in their proper historical context. The collapse of Drexel Burnham Lambert, the main underwriter and arranger of junk bond issues, amid recrimination and scandal in 1990, and the consequent drying up of junk bond easy money to finance LBOs meant that private equity had to face up to the fundamentals of its investment approach, rather than relying on financial alchemy to deliver returns. Would the business being evaluated perform well, with or without leverage? How competent or skilled were the management team? How could their skills be supplemented? How could cost discipline be introduced into the business? Assuming that an investment was made and all went well, what were the means of exit for the private equity firm among the public or private markets?

The tightening of economic conditions at the beginning of the 1990s and the consequent slowdown in M&A activity inevitably led some commentators to question private equity as a viable investment class and to focus attention on trying to grow the equity of an acquired business, rather than on applying more debt via the highly leveraged model. The lessons of the 1990s are equally applicable today; private equity investors would be well served in remembering what recent history teaches us.

6. New players and strategies

During the 1990s private equity firms continued to expand their own operational capabilities and portfolio management skillsets to cope with the change in the economy and more difficult conditions in which to find and produce superior returns. 'Turnaround' private equity firms emerged, where the ability to run businesses for cash and to restructure their operations became even more important than a consideration of which financing multiples could be applied to the company. Often these private equity firms would hire key senior personnel or distinguished chief executive officers from established blue-chip corporations, whom they would then parachute into an existing portfolio business, either to supplement the skills of the existing managers or to replace them entirely. In these firms, managing each portfolio business post-acquisition and extracting value became at least as important as, or sometimes more important than, acquiring the business in the first instance.

Additionally, as the technology boom and rise of the Internet fuelled the dotcom bubble of easy lending and rising stock markets globally, at the end of the 1990s a number of venture capital firms emerged, particularly in the United States, dedicated to investing funds in start-up companies with limited profitability or management track records, but with more upside than less glamorous, but stable, cash-generative companies. Some of these investments, particularly in Silicon Valley, were spectacular while they lasted, but resulted in non-existent returns or significant losses for investors when the financial markets finally corrected and indeed collapsed in 2000/2001. As before, history has proved that it is relatively easy to make money when debt is cheap and economic conditions benign, and even easier to lose all those gains and post a nil return when the cycle turns.

7. The effects of September 11 2001 and increased public regulation of financial markets

By the time the events of September 11 2001 occurred and highlighted the systemic deficiencies in the world economy caused by a decade or more of low interest rates and a consumption-led consumer boom, private equity was a global business, intrinsically linked with, and therefore a prisoner of, the twin global worlds of corporate finance and M&A. Therefore, it is not surprising that private equity, as with M&A, remained relatively quiet as the world economy went through a sustained recession from late 2001 onwards.

In Europe, private equity players were relatively unscathed by the ravages of the 2001 to 2004 collapse of the nascent European high-yield market and energy space (caused by deregulation). Although some leveraged buyouts had been conducted in the telecommunications and cable sectors generally, European private equity had largely invested elsewhere, meaning that while there were one or two examples of portfolio firms defaulting on their loans during this contraction of economic activity, the asset class was less troubled than some doomsayers predicted at the time.

However, the collapse of Enron and WorldCom and a number of other fraud-related cases in the United States did result in increased financial regulation of public corporations, not least via the introduction of the Sarbanes-Oxley Act, the US legislature's reaction to malfeasance in corporate America. Again with hindsight, this led to a sense among some US corporate managers that the extra regulatory burden imposed by the Sarbanes-Oxley Act meant that the opportunities afforded by private equity ownership were a panacea for their problems going forward and ensured that private equity was once again in vogue in corporate America.

This is an extract from the chapter 'The place of private equity in corporate finance and mergers and acquisitions' by Justin Bickle in Private Equity: A Transactional Analysis, Third Edition*, published by Globe Law and Business.*