

# Private Equity Hitting Warp Speed

By Paul Sweeney

SPECIAL REPORT

CAPITAL MARKETS

These are heady days for the private equity industry, which has seen a cataract of capital gushing into the marketplace. According to the Private Equity Analyst, a Dow Jones publication, a record \$215.4 billion poured into private equity in 2006. Of that, \$148.8 billion went toward buyout funds, 33 percent greater than 2005, the previous record year.

The result of all that money — mostly raised from pension funds, endowments and other institutions looking for ways to beat the equities markets — is that outsized takeovers of huge public companies are shattering all previous records for deal size.

To engineer eye-popping deals, firms are joining forces in “clubbing” arrangements that pool billions of dollars. A case in point: the \$21.2 billion in equity alone ponied up for the buy-

out of health services company HCA last July by Kohlberg Kravis Roberts, Bain Capital and Merrill Lynch Global Private Equity, all of which teamed up as equity partners.

At the same time, deal-making is raging in all segments of the market. Whole divisions of huge conglomerates — such as Hertz, a division of Ford Motor Co. — are being hived off, loaded up with debt and operated more profitably by private equity shops in preparation for either an initial public offering or a resale. And independent and family-run businesses in the middle-market are either selling out completely to private equity firms or partnering up with them.

Increasingly, private equity firms are combining or “rolling up” niche companies, such as regional food, packaging or printing businesses, to

Buoyed by a flood of investments seeking higher returns, private equity firms are busily doing buyouts and even joining forces for huge deals. And, there appears to be no let-up in the mega-deals trend this year.





create national conglomerates. The phenomenon is helping jack up prices across the board, industry sources say, making for a seller's market.

Prices are now at 10-12 times cash flow, which is usually calculated as "earnings before interest, taxes, depreciation and amortization," or EBITDA, according to an October study by the Association for Corporate Growth (ACG), the private equity industry's trade association, and Grant Thornton.

Eric Malchow, managing director at Lincoln International, a Chicago-based boutique bank that specializes in brokering sales of middle-market companies to private equity firms, says that as recently as 2003, companies were being sold at roughly six times cash flow. "It's the perfect sunny day," Malchow says of the current environment.

"We don't see any slowdown in the marketplace coming in 2007."

Malchow has lots of company. A recent survey by ACG and Thomson Financial discloses an industry in a state of near-euphoria. The survey found that a supermajority of global players — 85 percent of 1,200 investment bankers, private equity fund managers, lawyers, accountants, consultants and other professionals from 45 states and 25 countries — expects 2007 to equal or surpass last year's record \$3.8 trillion in global mergers and acquisitions. A scant 12 percent in the survey expect a slowdown.

(Compare that to the results from a survey of more skeptical CFOs. Only 8 percent of 1,400 U.S. CFOs polled by Robert Half Management Resources late last year expect an increase in public companies going

private this year; moreover, just 27 percent expect merger levels to increase, and fully 65 percent predict no change.)

Meantime, the share of M&A deals involving private equity transactions has grown at a furious pace. In 2006, reports statistics-gathering firm Dealogic, private equity deals accounted for one-third of all M&A deals, a sea change compared with a mere 3 percent just five years ago. "It has really taken off," remarks Thomas Franco, a partner at Clayton Dubilier & Rice, one of the largest U.S. private equity firms and a club member in the Hertz acquisition. "The drivers have been both the capital raised and the aggressive, liquid debt markets," he says.

In many cases, that deal-making power is putting the private equity

firms in direct competition with corporations and even other private equity firms. (Both are known as “strategic buyers” in the lexicon of the private equity industry.) And, in the foreseeable future, industry sources see no let-up in the mega-deals trend.

Dan Varroney, president of the ACG, notes that when the more than \$800 billion now in private equity war chests is added to their borrowing power, some \$2 trillion in capital is champing at the bit to be spent on buyouts. “And by 2010,” Varroney marvels, “we could have almost \$3 trillion in combined capital.”

All that liquid capital is having a range of palpable effects. Even as there is some concern over whether the current markets are officially in a

real estate are likely to be among the hotter sectors, firms are moving into less traditional properties. Technology companies, an area that was once shunned as too volatile and unstable, are suddenly hot.

Examples of companies that have been taken private in recent years include Sungard and Freescale Semiconductors. “Ten years ago, you’d never see an LBO firm going after a technology company,” says Doug Brockway, managing director at Innovation Advisors, a boutique investment bank. “They didn’t have the right characteristics for a buyout: stable and positive cash flow, loyal customers and the ability to handle leverage.

“But the industry has matured,” he adds. “And now, there are relatively predictable cash streams, espe-

attractive. Recent technology deals, Lawrence notes, are also marked by “not using traditional leverage. The amount of equity is large and debt service is smaller.”

Sunil Dhaliwal, a partner at Battery Ventures, a Boston-area firm that is among the most active buyout firms in technology, says that one appeal is that many of the companies have been undervalued. In 2003, the firm acquired Made to Manage, an Indianapolis-based technology company that makes “enterprise resource planning” software that simplifies an array of financial, manufacturing and inventory chores for middle-market companies, in a \$30 million buyout.

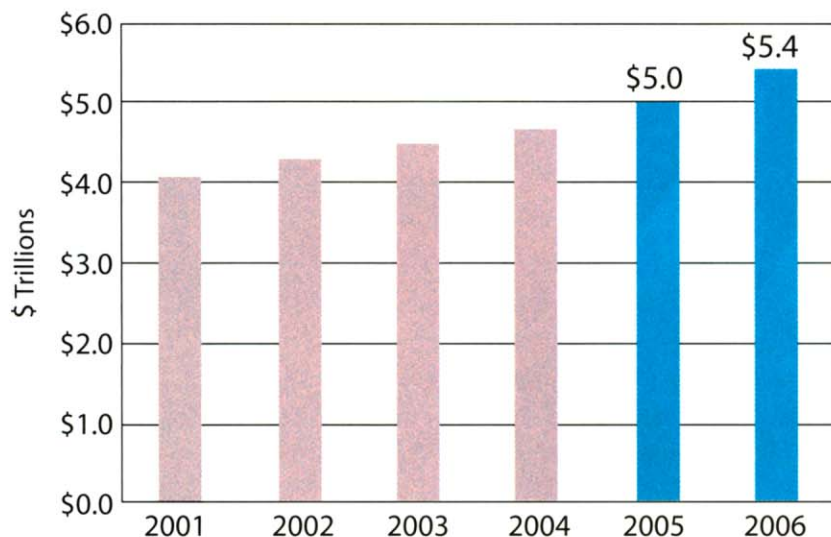
Since then, he says, the firm has used Made to Manage as a platform to “bolt on” several additional acquisitions. But Dhaliwal warns that technology deals are not for everybody. “You have to have a lot of industry expertise. These businesses are different from companies with hard assets that you can get your hands around.”

Contributing to the buyout craze is the phenomenon described as “convergence,” the tendency of private equity firms and hedge funds to become gradually indistinguishable. An ACG/Grant Thornton study in October 2006 noted that such well-known private equity firms as Bain Capital, KKR, Blackstone Group, Carlyle Group and Texas Pacific also offer investors “hedge fund alternatives.”

And hedge funds such as Cerberus Capital Management and D.E. Shaw “are becoming more involved in private equity-type investments,” the ACG/Grant Thornton report declares, adding: “The acquisition of Kmart by hedge fund ESL Investments and the subsequent merger with Sears is a hedge fund transaction that looked very much like a private equity buyout.”

Franco, the CD&R partner, says:

### Total U.S. Corporate Liquidity



Source: Treasury Strategies 2006 US Corporate Liquidity Survey

bubble, deal size continues to escalate — so much so that there is speculation that a \$50 billion or even \$100 billion transaction could be possible. Indeed, the *Financial Times* even posed the question: Could Microsoft go private in an leveraged buyout (LBO)?

U.S.-based private equity firms are also venturing into untraditional areas. Increasingly, they are moving abroad — not just Europe, but to Asia as well. And while energy, health care, media and entertainment and

cially as the companies have gotten bigger. You’re also seeing buyout firms finding companies with positive cashflow and then growing them with follow-on deals to add to their products, geography and so on.”

Glover Lawrence, managing director at McNamee Lawrence & Co., an investment bank with offices in Boston, San Francisco and London, agrees, noting that “technology is a fundamental part of most businesses,” making proven companies more

"There is a trend at the higher-end firms to have multiple platforms. Texas Pacific, Carlyle, Blackstone and KKR all have businesses that are not buyout businesses. Carlyle is broad-based, with 46 funds. For many, branching out is a natural consequence of their scale. They're beginning to look more like a big mutual fund like Fidelity."

The private equity firms are also behaving more like such hedge fund investors as Carl Icahn, the raider-turned-activist investor who is now shaking up ImClone. And some are even being likened to uber-investor Warren Buffett, taking huge positions in undervalued companies and seeking influence over the company's performance.

In January, for example, Kohlberg Kravis used KKR Private Equity Investors, its publicly traded, Guernsey-based arm, to take a highly publicized \$700 million stake in Sun Microsystems. In return, KKR gets to name an appointee to the board, sparking rampant speculation as to its true motives.

Companies like KKR, in fact, are exerting global reach. So, while they are beginning to look like diversified investment firms, they are also beginning to resemble multinational corporations. "Our global perspective not only helps us make better investment decisions around the world, but also strengthens our ability to improve our portfolio companies — wherever they may be," Henry Kravis, co-founder of KKR, declared in a recent speech. "We can help our U.S. and European companies globally source key parts, shorten supply chains and enter new markets due to our Asian presence."

Many law firms, accountants and consultants are moving to take advantage of all the pecuniary excitement. Robert Jensen, the Chicago-based director of consulting services for the Great Lakes economic unit at RSM McGladrey, the country's sixth largest accounting and professional services firm, says his firm has had to gear up to meet the demand for due diligence services and other chores

occasioned by a buoyant private equity market. "We've just awoken to the fact that the middle-market landscape is changing and there is a need for transaction support," he says.

Fund managers, too, are tailoring their investing strategies. TIAA-CREF, the pension fund with \$406 billion in combined assets under management and the leading provider of retirement saving products and services in the academic, research, medical and cultural fields, commits \$1.5 billion annually into myriad private equity investments "in all stages of business life-cycles — from startup to large buyouts to when companies are turnarounds or restructurings," says Sheryl Schwartz, managing director for fixed income and real estate.

In addition, the fund will take a piece of the action in leverage buyouts by supplying direct mezzanine financing. It is also scanning the globe for niche opportunities. "We are increasing our Eastern European exposure," Schwartz says. "Valuations are still attractive, and these countries are becoming part of the European Union."

While welcoming the avid attentions of investors, some private equity veterans say that the current environment can still prove vexing. Scott Perricelli, a principal at LLR Partners in Philadelphia, laments both the "frothy" nature of the current market and the rapidity of change.

"There is a ton of capital out there, and you're seeing a bunch of different investors getting into the act — hedge funds and the BDCs," he says, referring to business development corporations such as Allied Capital and American Capital Strategies. "We're having to compete with them on a lot of deals."

The firm aims to return 500-1,000 basis points above the S&P 500 to its investors, but that's not exactly a slam dunk. "Hedge funds are investing debt directly into private equity deals," Perricelli says. "It's definitely getting more expensive, and it's going to impact on returns."

The auction process can be partic-

ularly irksome. Having 100 different private equity firms bidding on a middle-market company, he says, has transformed what was once a relaxed, one-on-one courtship into impersonal match-making. He has little enthusiasm, moreover, for the emerging trend in which private equity firms are becoming strategic buyers of previously LBO-ed companies.

"We don't like to do it," Perricelli says, "because it's going to be a very savvy seller. You're buying from someone who's trying to maximize an investment, and the heavy lifting has already been done."

As to whether a \$100 billion is in the offing, Dhaliwal of Battery Ventures sums it up best. "Theoretically, a \$100 billion deal could be done. But, practically, the answer is 'no.' You would have to find a company that you can ultimately monetize... Practically, the law of large numbers starts working against you."

Shareholders are also fretting that everyone, it seems, has been benefiting from sweetheart LBO deals except them. Now, some have been pushing back. Notable examples include the directors at Cablevision, who thwarted attempts by the Dolan family to take the company private, and current resistance of the Clear Channel Communications takeover deal led by Fidelity Investments, the fund giant.

And the fat lady still hasn't sung on the clubbing phenomenon. If the economy heads south — the result of war, energy shortages, oil price shocks, a tightening of money by the Federal Reserve or something else — the clubbing phenomenon could boomerang.

"What will be interesting to see," says Bill Wexler, who heads the corporate advisory group at BBK, an international business advisory firm, "is when one of these huge deals hits the wall and five funds sit around the boardroom and talk about how wrong each of the others was."

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