The Private Equity Boom: Causes and Policy Issues

Adrian Blundell-Wignall

Private equity plays a valuable role in helping transform under-performing companies. M&A and private equity deals are very strong at present, and use of leverage in deal making is accelerating sharply, as it did in the late 1980s. The process is being driven by a number of factors, particularly low yields which result from excess global liquidity.

The accommodation of leverage is fungible with innovative global financial markets, and policies to fix the price of money in some parts of the world make it difficult to control supply (as they did in the Louvre Accord period in the late 1980s). The arbitrage opportunity that has been opened up plays a key role in driving asset price inflation, including stock prices through private equity deals. As the LBO process moves into its mature phase, deal multiples are bid up in the industries and companies where the activity is concentrated. Strong investor demand, together with readily available finance, increases the pressure to find new deals, driving down yields.

Excess concentrations of leverage can give rise to financial stability issues. However, policies that contribute to excess global liquidity are difficult to change in the short run, because domestic concerns in some countries are overridingly important. Firms and financial intermediaries therefore should be strongly encouraged to perform stress tests and to maintain strong credit checking processes, particularly with regard to the sustainability of debt at a more normal cost of capital. Credit rating agencies need to apply high standards to credit risk transfer products, and sound principles of corporate governance are required to ensure moral hazard issues do not exacerbate things.

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Executive summary

- Private equity, by focusing on under-performing companies that can be transformed and subsequently re-floated, fosters rapid corporate restructuring – enhancing productivity.
- M&A and private equity deals are very strong at present, and private equity use of leverage is accelerating sharply.
- The process is being driven by a number of factors, particularly low yields. These have opened up a massive arbitrage opportunity for companies and investors to buy higher yielding assets generally. Hedge funds do this across a variety of assets – but private equity is taking up the same opportunity to use leverage to buy higher yielding corporate assets in the listed equity market – to take companies private and augment returns even further.
- Low yields result from excess global saving and liquidity. They risk pushing leverage and equity prices in parts of the corporate sector to excessive levels.
- Wherever strong growth in LBO activity emerges across a broad range of global industries, it is likely that it is being accommodated by distortions somewhere in the global

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financial system: *i.e.* fixing the domestic opportunity cost of money, or the international price of money (the exchange rate), at a too-low level. Innovative financial markets will take advantage of it.

- As the LBO process moves into its mature phase, deal multiples are bid up in the industries and companies where the activity is concentrated. The strong growth of capital available to private equity resulting from strong investor demand, together with readily available finance, increases the pressure to find new deals. This is driving down yields into line with (too low) interest rates. As this process continues it becomes more risky.

- It is excess concentrations of leverage that give rise to financial stability issues rather than the average level of debt for the economy as a whole.

- 'Global' policy would ideally focus on removing distortions that create excess global liquidity, but sometimes domestic policy considerations in some regions make this difficult. This raises the question of what else can be done.

- Firms themselves should be strongly encouraged to stress test their ability to cover interest costs for more normal levels of interest rates, including any related impact this might have on supply and demand conditions in their industry, before recommending bids to shareholders.

- Financial intermediaries should be encouraged to maintain strong credit checking processes even if debt is shifted off balance sheet via securitisation. Credit rating agencies need to apply high standards to credit risk transfer products.

- Financial intermediaries should be strongly encouraged to stress test their exposures, and to ensure they have adequate capital to cope with credit events that may arise over the LBO cycle.

- Moral hazard conflict of interest mechanisms may also contribute to pushing the leverage process too far in individual companies and sectors. Issues here include: the fee structure of deals, systematic removal of downside risk by refinancing profit lock-ins, misuse of private

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information and insider trading. Insider trading is evidenced by the movement in share prices and credit default swaps prior to the public announcement of deals.

- In this context, there may be some role for private equity industry bodies to help with transparency by better clarifying 'fair and reasonable' rules of the game. Better cross-border self regulation and transparency with respect to these issues could be very useful. There is a need to strike the right balance between the need for commercial confidentiality and the misuse of private information.
- Private equity plays a valuable role, in helping transform under-performing companies. Finding an approach to policy that does not inhibit these productivity-enhancing activities, while ensuring that leverage does not become too excessive and fair and reasonable rules of the game are adhered to, is the key policy issue at the micro level. This is especially important at times when liquidity is plentiful in the global economy, and rates are too low.

I. The private equity value proposition

Private equity has a limited partnership structure

A private equity firm is usually structured as a limited partnership.

The General Partner (unlimited liability) receives capital from the limited partners (pension funds, insurance, rich individuals, hedge funds etc.), and pays the managers and other consortium members out of fees. A consortium of the equity providers, advisers and lenders is put together for each targeted buyout bid.

Figure 1 shows the main elements of the private equity value creating proposition.

Capital structure

The whole point of private equity is to transform capital structures with debt, and shift the risk from equity to debt holders

The main feature of a private equity deal is the high reliance on debt. A simple arithmetic example is shown in Table 1.

The key feature is leverage – the whole point is to transfer risk to lenders and enhance the return on equity for the investors. An under-levered,

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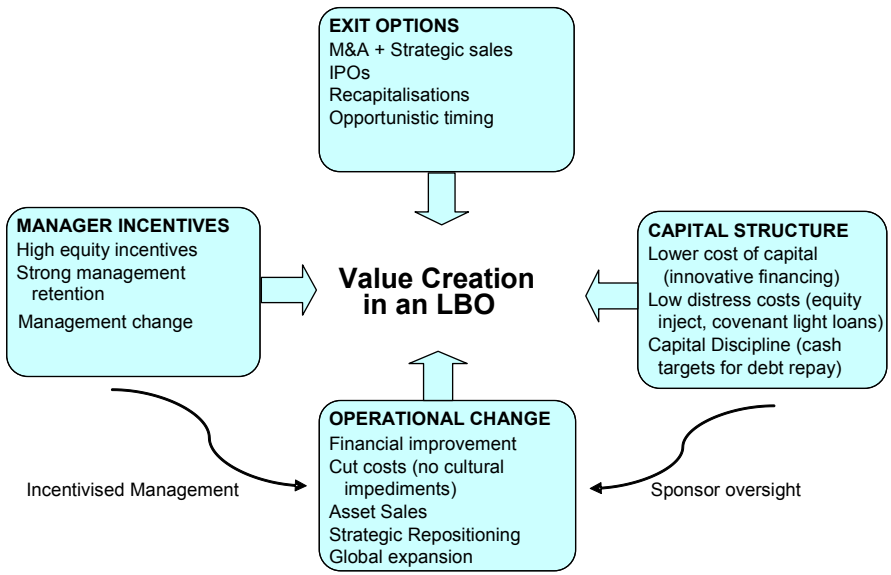
underperforming company is targeted. In the deal phase, a 70% debt and 30% (private) equity structure (shown here) is typical (though 80% debt is not uncommon). A premium of say 20% (shown here with the price-earnings ratio, PE, of 10) is offered over the listed price. The debt level associated with the acquisition rises sharply, usually to 5 to 8 times earnings before interest and tax (EBIT, here 7 times). Debt service rises sharply, profit before tax falls significantly, but due to the tax deductibility of interest, after-tax profit falls less. The return on the private equity virtually doubles. Of course the (typically) 2% of the total value of the deal, paid up front in fees, adds to the immediate benefit of fund manager remuneration and the partners in the deal.

Figure 1. The private equity value proposition



Source: OECD

Innovative financing is important; debt cost can be cut and liquidity management improved

Structures have changed over the years. Innovative financing is used to reduce costs and manage liquidity. In 1989 the RJR Nabisco USD 31.4 billion deal was 9.6% equity, 20.1% equity-like debt, 31.5% subordinate debt and 38.8% senior debt. In 2006 the USD 32.1 billion HCA deal was 19% equity, 38.2% subordinate debt and 42.8% senior

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debt. Bank commitments usually fund the initial phase of the deal, as it is being put together (2-4 months). Banks then securitise once the deal is completed and after credit ratings are obtained. CDOs, CLOs, swaps, fixed/floating, second liens, non-amortising components may be used, depending on the geography and nature of the deal. In the recent HCA deal, some of the senior debt has a toggle feature, giving the borrower the option to pay interest in 100% cash; 50% PIK (pay-in-kind interest payments by extending the loan) and 50% cash; or 100% PIK – depending on what suits

Table 1. Arithmetic example of a private equity deal

Public Company		The Deal Phase Period 1		Exit Yr4 ,10% Growth	
Market Cap $m	100	Mkt Cap, (20% prem bid) $m	120	IPO Value	315.0
EBIT (margin 10%) $m	12	EBIT (margin 10%) $m	12	EBIT (margin 20%) $m	35.1
Sales $m (costs 108)	120	Sales $m (costs 108)	120	Sales $m (costs 140.6)	175.7
PE (vs say peer avg of 10)	8.3	PE (vs say peer avg of 10)	10.0	PE exit 10% disc. to deal mult.	9.0
Debt on balance Sheet (1xEBIT) $m	10	Debt @ (7x EBIT) $m	84	Debt $m--constant target	84.0
Debt service @ 7%	0.7	Debt service @ 6% $m	5.04	Debt service @ 6%	5.0
Net profit before tax $m	11.3	Net profit before tax $m	6.96	Net profit before tax	30.1
Profit after tax @ 30%	7.91	Net profit after tax @30% $m	4.872	Net profit after tax @30%	21.1
		Equity contribution to deal $m	36	Compounded equity at cost of K	45.4
Yield %	7.91	Yield for Priv Eq investors %	13.5	Yield % on Equity	46.4
		Yld incl.up-front fee @2%	20.2	Capital gain % on Priv Eq	774.9
				Capital Gain on public Company	214.98

Source: OECD.

Access to capital and use of low covenant loans help

The ready access to capital injections in private equity funds – by drawing down capital not yet invested, or by asking investors for more – helps reduce risk spreads. Swaps can be used to stream interest payments in line with the currency of different companies in the portfolio.

The use of low-covenant loans, and the ability to negotiate with lenders facilitates liquidity management.

Venture capital can also be obtained from private equity, allowing a whole class of new technology enterprises to obtain funding that would not otherwise happen.

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Operational change

Private equity helps restructure poorly performing companies, reallocating capital in an efficient way, increasing productivity

After the deal is completed, the private equity managers get full control of the company. They are not distracted, as with public companies by corporate reporting and market focus; by dealing with shareholder meetings and all aspects of corporate governance; by dealing with brokers and their analyst reports; etc.

They can quickly sell non-core assets, sometimes to other entities that they own where there are better synergies and savings.

Stringent cost reductions follow, spurred by the need to repay the debt quickly. Duplication of back-office functions can be removed, particularly where assets are being sold and acquired. More flexible labour arrangements can be pushed through more easily.

Equity incentives

Equity incentives are used to retain staff and keep focus on improvement of the company

Equity incentives of ½-1% of the deal size are 'normal'. This is to attract and maintain good managers in the company. This stability is critical in the operational change phase.

There are restrictions, such that management can't exit before investors. They would forfeit any equity on premature termination of their contract. Sometimes management is tied with loans to buy equity stakes.

Any existing management equity options in the listed vehicle fully vest upfront, as soon as the deal is completed – a huge incentive.

Exit phase

Private equity companies can exit at the most opportune time, when the company is ready – debt reduced and margins improved

The private equity company will sell the company after it is fully transformed. In a non-mark-to-market environment, it can choose the best time to sell, and the best available option; for example, an IPO, or a trade sale to a strategic listed or unlisted buyer.

It can sell to entities where the regulatory and tax environments are better, and it can choose regionally where

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the depth of capital markets are best suited (without for example of going through all of the corporate governance issues of listing changes, etc.).

In the above arithmetic example, the company grows at 10% p.a. for four years and doubles the EBIT margin from 10% to 20% in the operational change phase, while keeping the nominal level of debt constant (thereby dramatically cutting the debt equity ratio and raising interest cover).

Even if the company re-lists at a 10% discount to the earnings multiple of the original deal (a PE of 9), the returns shown are extraordinary.

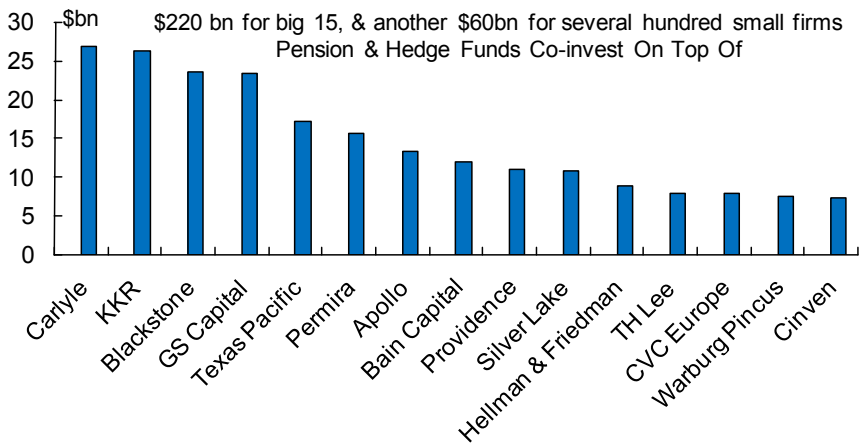
Private equity firms and their size

Capital available to private equity is booming

The main private equity firms are shown in Figure 2. The data are based on H1 2006, and the growth in capital has subsequently been strong. It has to be remembered too that there is currently excess demand for private equity investments (limited partnership pools are quickly filled, and not fully drawn down into LBO investments). So capital can be added to readily.

Figure 2. Major private equity companies

As of H1 2006



Source: OECD

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Furthermore, pension funds, hedge funds and other private equity firms can co-invest in deals.

There is no doubt, that while interest rates and spreads are low, the search for yield is accelerating the private equity process.

Which industries?

Industries with stable cash flows are preferred

Industries with more stable cash flow over the economic cycle are attractive to private equity companies. In Anglo-Saxon countries, consumer products (*e.g.* beverages, tobacco, and foods) and retail companies benefiting from non-discretionary spending are popular. RJR Nabisco (KKR) was the most famous of these (a staggering 1.6% of the S&P market cap in 1989 which has not yet been surpassed in size). The 2006 USD 17.4 billion Albertsons (KKR) takeover by Supervalu is a more recent example. Healthcare is popular as the July 2006 USD 32.1 billion buyout of HCA (KKR) illustrates. Utilities also have this characteristic – witness the KKR Texas Pacific TXU USD 44 billion deal. Selected stable industrials (*e.g.* Hertz September 2005; Carlyle) with stable monopoly-like markets are also attractive. In the energy area, the US pipeline operator Kinder Morgan was bought out in May 2006 for USD 26.5 billion (Carlyle and others). Semi-conductor companies also have stable demand from the explosive growth in the numerous (higher risk) technology companies: *e.g.* the USD 17.6 billion Freescale deal (Blackstone, Carlyle, Permira, Texas Pacific).

In Japan and Chinese Taipei financials are attractive, as they are less cyclical than is common with investment banks in Anglo-Saxon countries. Semi-conductor companies are also popular in Asia.

Which companies?

Cheap, poorly-performing companies with under-geared balance sheets are preferred

As with the above arithmetic example, private equity firms seek companies with under-geared balance sheets, so that recapitalisation adds immediately to yields.

- They choose companies with margins below peers (*e.g.* because of low productivity, bloated

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overheads, or poor operating leverage) which can be improved, or where they can be combined with other companies to achieve cost-saving synergies.

- They choose companies with cheap valuations versus their peers.
- They choose companies with high free cash flow (cash flow after replacement investment) – reflecting the fact that interest payments after the deal will be much higher.

Good companies become harder to find as the cycle matures, so risk in leverage rises

But as the LBO process moves into its mature phase, these companies become harder to find, and the risk of poor (over-leveraged) deals increases. We are entering this phase now.

Performance of private equity funds

As this discussion illustrates, private equity is an agent for rapid structural adjustment and productivity enhancement. While there will always be failures, the financial return evidence to date is broadly favourable for private equity in some geographies.

Private equity returns are solid in the US and Europe, with clear evidence of productivity enhancement

The overwhelming US finding, using Venture Economics data (obtained under freedom of information laws) and data obtained directly from general partners, is that private equity fund returns gross of fees substantially outperform benchmark indexes such as the S&P500.[1]

In the Groh *et al*. study,[1] the data are from 1984 to 2004 and cover 133 private equity transactions which closed in 1984 and were completely divested by 2004. Regardless of debt, the sample outperformed (gross of fees), but the sensitivity to the degree of leverage whereby the risk is transferred to the lenders is very strong indeed – the more the risk is transferred by leverage, the better the performance. The correlations with listed securities are so different, that the authors make the point that private equity is a clear separate asset class with great diversification attributes.

1. See Kaplan, S. and A Schoar, "Private Equity Performance: Returns Persistence and Capital", NBER *Working Paper* 9807; and Groh, A. and O. Gottschalg, "Risk-Adjusted Performance of Private Equity Investments", INSEAD *Working Paper,* 2006.

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A broad summary of a recent consultant's report to the OECD shows that the US results are not unique – UK and European buyout fund performance has been strong, too.

In terms of real effects, as might be expected, evidence from Continental Europe and the United Kingdom shows that deals enhance productivity (*i.e.* more efficient use of, and the elimination of any surplus, labour).[2] The complex normative issue concerning the long-run effects of private equity on overall employment in a country lies outside of the scope this paper – these effects depend on interactions between the dynamic benefits of financial innovation on productivity and growth, the impact of competition from the rapidly industrialising BRIC economies (Brazil, Russia, India and China), the nature of public labour market policy and the business cycle.

Investor demand

Investor demand for private equity typically outpaces supply at this stage of the cycle

Given solid performance and the diversifying characteristics of private equity investments, it is not surprising that cornerstone investors such as hedge funds, mutual fund managers, insurance companies and pension funds have sought to increase their exposure to this rapidly growing asset class in their fund allocations.

Investment demand typically outstrips the available supply of private equity products while liquidity conditions are favourable. Failures become more frequent in the mature phase, as interest rates move up (via policy or risk events that push risk spreads out).

With readily available capital from strong investor demand, which is combined with easy access to debt in an environment of low rates and excess liquidity, it is hardly surprising that private equity-led LBOs are booming.

2. See Wright, M., A. Burrows, R. Ball, L. Scholes, M. Meuleman, and K. Amess, *Private Equity and Investor Led Buyouts*, OECD Report, 2007, which surveys some studies on real effects of privatisations.

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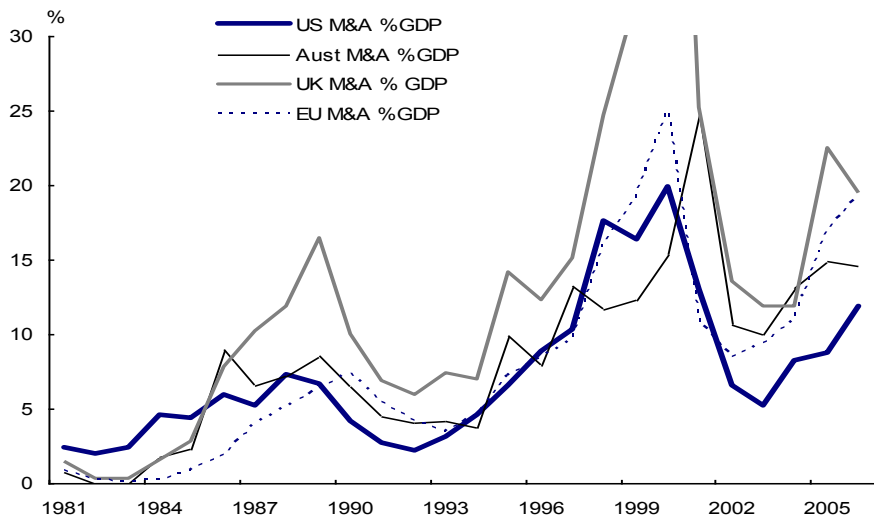
II. Private equity: LBOs are booming

Overall M&A is booming again, but not as strongly as the tech bubble, but LBOs are now back in the excess liquidity environment of late 2000, with deal flow in excess of anything seen before

Figure 3 shows M&A of all forms in per cent of GDP for the United States, Continental Europe, the United Kingdom and Australia. The massive M&A boom in the late 1990s was driven by scrip deals in the tech boom, when scrip acquisitions using massively overvalued paper were common. M&A via scrip in an asset bubble tends to dissociate buyout activity from interest rates. The other two episodes, in the late 1980s and today, are smaller by comparison. But deals at the moment are certainly running at a faster pace than in the late-80s boom.

The deal making is particularly strong in the United Kingdom and Europe. It is difficult to make any qualitative judgment about this observation, as Europe is undergoing massive structural changes in the face of global pressures coming from Asia and Eastern Europe. Private equity is likely to be a highly desirable catalyst to change.

Figure 3. Total M&A selected regions



Source: Thomson Financial.

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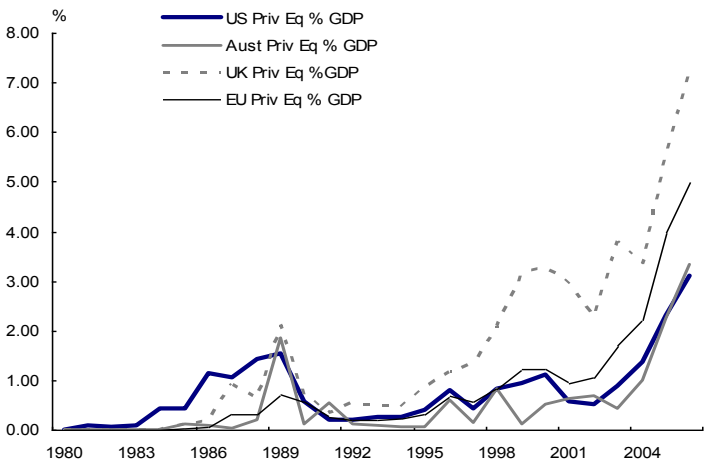
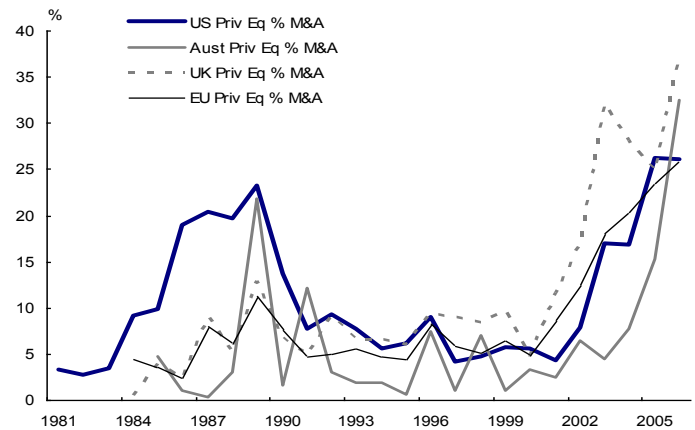
Total private equity in the 4 regions is shown in Figure 4, back to 1980, as a share of GDP. Only 2 periods, the late 80s and today, stand out as major LBO debt phenomena for all regions.

Figure 4. All completed private equity deals in four regions



Source: Thomson Financial.

Figure 5. Private equity in per cent of total M&A



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Private equity deals in Europe and the UK are outpacing the US as a share of GDP

The United States was more consistently the largest player in the first LBO boom, but Continental Europe and the United Kingdom are larger this time. The current boom in private equity, as a share of the economy, is much stronger than the previous late-80s LBO boom – which did end in tears and a number of criminal charges by 1991. Private equity deals have begun to branch out recently in a spectacular way to regions like Australia.

Private equity LBOs are 25-30% of M&A at present

As shown in Figure 5, private equity as a share of total M&A is now higher than the late 1980s (around 25-30%).

Causes of the private equity boom: why now?

Markets behave in rational ways in response to the price and regulatory signals they are given.

Why the boom is occurring now

- As debt is involved, a key signal is the level of interest rates and the arbitrage opportunities to which they give rise. This is ultimately an issue of global savings availability and liquidity policies. Liquidity and savings are plentiful, and rates are low, often driven by derivative convergence plays.
- Corporate balance sheets and profits are very strong at present, and are attractive in the search for cash yield, while debt funding is cheap.
- Equity financing was expensive after the tech bust.
- Corporate governance pressures and related requirements have increased, while the ability to reward managers with options has been reduced (Sarbanes–Oxley).
- Short-term performance pressures on fund managers have reduced holding periods of listed equities and made it more difficult for managers of companies to take long-term decisions.
- Asset allocations to this high-performing and low-correlated asset class have increased available capital strongly.

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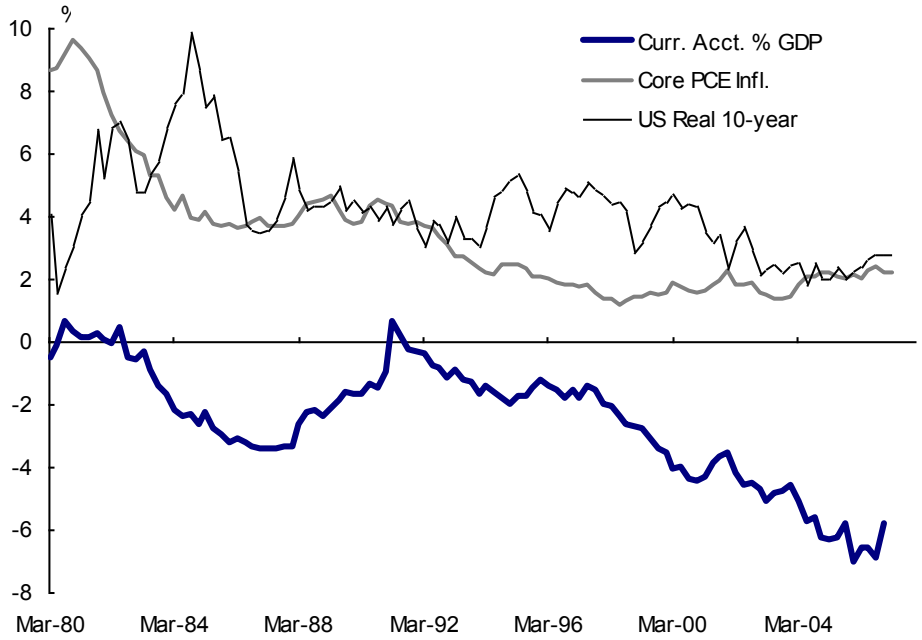
III. The excess liquidity and arbitrage issue

Low rates set up an enormous arbitrage opportunity that is feeding the LBO 'frenzy'

Given the interest rate and other signals set by policy makers, markets behave in very rational ways. Real interest rates are unusually low for this stage of the cycle. At the fundamental level this is due to excess (ex-ante) saving and permissive liquidity policies in parts of the world. Strong demand for long duration assets (in short supply) from pension funds for liability matching reasons is also a factor. Investors respond to these signals. **A massive arbitrage opportunity is set up to borrow at low rates and buy higher yielding assets.** Carry trade activities by hedge funds reinforce the downward pressure on yields. Equity LBOs are a part of the same arbitrage process.

Figure 6. US real 10-year bond, current account and inflation



Source: Thomson Financial Datastream.

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Excess savings are one factor in low rates

Figure 6 shows the US real 10-year rate, inflation and the current account. The current account equals the ex-post tapping of excess world saving by the United States. The ex-ante excess saving in the world economy reduces real interest rates, boosting asset prices, demand and imports in saving deficient countries. **In the United States real yields have fallen from 4.7% at the end of the 1990s to around 2.7% in 2007Q1.**

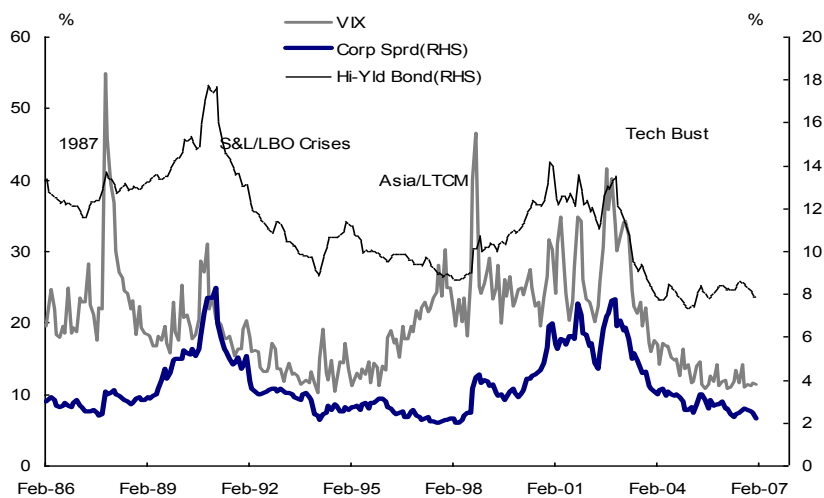
Spread trades via derivatives operate to lower high* versus *lower risk premium assets – setting up yield convergence

Spread/carry trade activities of hedge funds use derivatives to play the arbitrage opportunities presented. Spread trades are implemented by writing (selling) puts – a bullish strategy that expects narrowing. There is an in-built bias to this strategy. The put sellers receive positive carry – the put buyers receive negative carry. The latter require a major event (reversal) to be profitable (LTCM was such an event in the 1990s). The longer the carry works the more self-reinforcing in becomes. This process results in spread compression across all sorts of assets (high *versus* low risk premium instruments).

The junk bond versus AAA spread is back near all time lows

In previous LBO boom episodes, the spread between junk and AAA bonds has been at historic lows (see Figure 7). This is the case once again.

Figure 7. Volatility, spreads and junk bond yields



Source: Thomson Financial Datastream.

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Sources of global excess liquidity

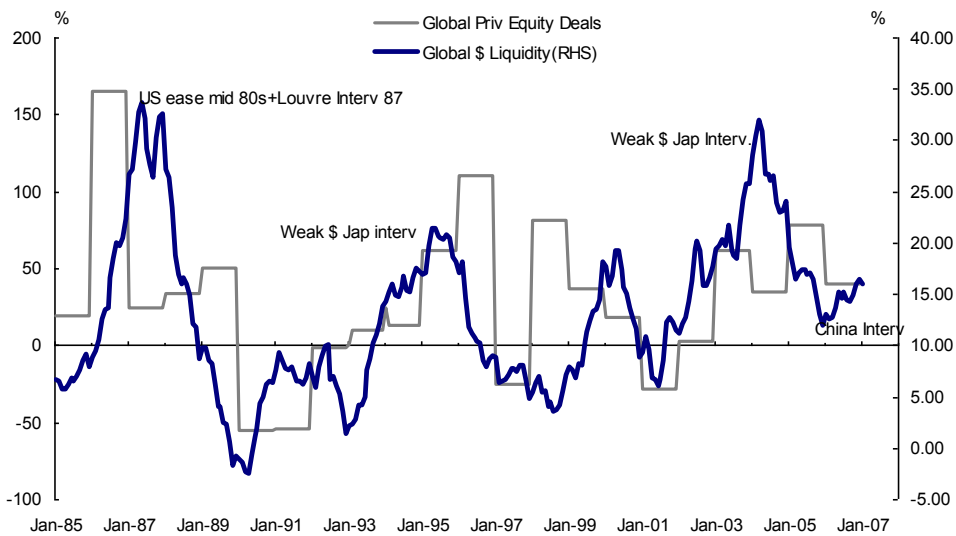
Excess global liquidity has its sources in global distortions

In global financial systems, particularly with the increased role of hedge fund and derivatives, liquidity and financing is not a matter of national monetary policy. It is a basic proposition that if one fixes the price of money in parts of the world economy, one will not be able to control its supply. The re-cycling of this money is an integral part of the arbitrage opportunity that is driving the private equity boom.

The two key prices of money are policy rates (domestic opportunity cost) and the exchange rate (one money in terms of another). Two major prices in the world economy worth noting in this respect are the near zero interest rates in Japan and the fixed exchange rate for the RMB.

Figure 8. Global liquidity and global private equity

Percentage changes



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The private equity deal cycle is correlated to policy-driven global liquidity

Figure 8 shows a simple concept of high-powered global liquidity measured in US dollars (the main financial transaction currency). This is equal to US base money, plus the foreign exchange reserves of the authorities in China, Japan, Asia, the United Kingdom and the euro area – *i.e.* high-powered money for the credit multiplier in the United States plus international reserve accumulation outside the United States which creates domestic liquidity. The US dollar assets are recycled into global (particularly US) debt instruments. The correlation of global policy-driven liquidity with the private equity data is quite striking, and is frequently related to attempts to resist exchange rate pressure in some region. Debt accommodation is a fungible process and financing techniques are innovative: transactions can run quite independently of the domestic monetary policy of the country where the transaction is taking place.

China is the largest contributor to this liquidity at present

Easily the main contribution to the measure of global liquidity in 2006 is Chinese foreign exchange market intervention. In the 12 months to January 2007, China accumulated a further USD 259 billion in reserves, and the stock of reserves stood at over USD 1.1 trillion. The recycling of these reserves into US bonds is a major factor keeping US rates low. At the same time the fixed exchange rate to the USD and the HKD afford all the usual mechanisms for avoiding capital controls (such as the failure to repatriate foreign currency receipts replaced by domestic loans). Within the Asian region, the ability fully to subscribe start-up investment vehicles quickly at present is well known.

While Japan has intervened less since the US dollar troughed in 2002, zero rates continue to contribute to the global liquidity and spread trades via derivatives that are difficult to measure through standard bank balance sheet flows.

The private equity arbitrage opportunity and risks

The arbitrage signals are favourable to LBOs

Figure 9 shows the 1-year forward equity earning yield minus the 10-year bond rate in the United States, Europe and the United Kingdom.

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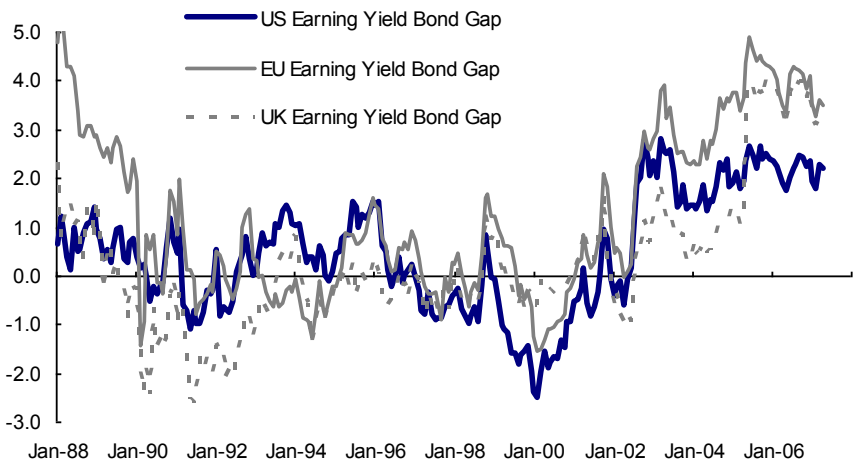
Compared to previous LBO booms, the signal to markets this time is to use debt – has global policy got this right?

In the 1980s bond yields were quite high but equity was very cheap (an expensive funding vehicle) so LBOs were quite strong. **In the late 1990s** equities were in a bubble and became very expensive (*i.e.* a very cheap funding vehicle for M&A), so scrip deals were the main diver of M&A. The equity-bond yield gap went very negative in this period. **In the current boom**, it is very clearly an LBO arbitrage environment.

Figure 9. Equity earning yield versus 10-year bond yield



Source: Thomson Financial Datastream.

The LBO boom will go on until equity prices are driven up to the point where equity yields are less attractive than bonds – if yields are too low, this spells trouble

Currently low bond yields mean that debt is a cheap source of funding for acquisitions compared to equities – the earnings yield bond yield gap is as high as it has ever been. Yields on equities, driven by strong corporate profit growth in recent years, are quite attractive relative to bonds. But it is not the case that equities are especially cheap – rather, bond yields are especially low. So in principle, if rates don't change, **LBOs will continue until equity prices are driven up to the point where their yields are less attractive** *versus* bonds.

It follows, that if bond yields are too low, for the reasons enunciated above, the process will go too far with adverse consequences for investors later on. Since debt is

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involved, credit events will follow, and the possibility of financial stability issues later on cannot be ruled out.

Don't shoot the messenger

It is important here **not to shoot the messenger**, as some pundits are wont to do. Private equity is a source of change and market efficiency. It responds to many signals, one of which is the cost of credit in the global economy. In this respect, policies that distort the global price of money in various jurisdictions are an important element in the acceleration of the private equity process.

Increased risk in deals rise as the cycle matures

In the sectors where private equity is focused, it is getting much harder to find good deals – but with low rates the process goes on, so risk rises

The UK Financial Services Authority (FSA) has calculated that UK deals to which banks committed capital were carried out at an average PE of 14 times in 2006, versus 11 times in 2005. This means that the PE cost of funding gap is closing in the industries and companies of interest to private equity companies. Private equity companies are paying higher prices for the right to apply their skills, so that simple changes in the capital structure may not be enough to generate good returns (*i.e.* the under-geared/under valued 'easy' sources of return), and much more will turn on the operational change phase of the process. Similar processes are under way in Europe. Table 2 shows earnings yield–bond yield gaps for the overall market and for the LBO sector, for Europe and for the United Kingdom.

Table 2. Yield gaps LBO sector versus the market

	Av Mkt PE	Av PE LBO	Av Bond	Yld Gap Mkt	Yld Gap LBOs
UK					
2005	13.9	11	4.4	**2.8**	**4.7**
2006	12.3	14	4.4	**3.7**	**2.7**
EU					
2005	13.2	17	3.4	**4.2**	**1.7**
2006	13	18	3.7	**4.0**	**1.6**

Source: UK Financial Services Authority; Thomson Financial Datastream; Wright *et al.*[2]

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Mega-caps distort the aggregate picture

This suggests that the aggregate equity market index yield *versus* bonds for the United Kingdom and Europe may exaggerate the signal for LBO arbitrage, because the broad indexes are dominated by mega-cap companies. Good value does still exist in mega-cap companies, but they are too big for LBO buyouts by private equity. The under-performance of mega caps has continued of late. The ten largest stocks in the main indexes (too large to be taken by private equity) have underperformed by a staggering -6.6% in the United States, -11.1% in Europe, -6% in Japan, and -8.9% in the United Kingdom over the six months to the end of March 2007, as private equity deals have accelerated.

Within Asia ex-Japan, LBO activity has been less because of the bubble-like growth in share prices and very low historical dividend yields that make scrip driven M&A more attractive. Internal rates of return (IRRs) are just too poor in most companies to make a debt-driven transaction attractive.

Deals are spreading to less appropriate industries

In Anglo-Saxon countries and Europe, deals are spreading to industries such as airlines that are inherently more cyclical and exposed to risk factors (*e.g.* oil prices and terrorism), or are looking more at banks and utilities, where perceived public policy 'put' comfort factors may be present.

Financial stability issues arise from concentrations of leverage

Financial stability issues arise from concentration of leverage risk, not from the average market picture. As the cycle continues to mature, making LBOs work gets increasingly tougher, and so leverage becomes more risky. Markets are only continuing to respond to signals with the profit motive in mind. But are the signals they are responding to appropriate?

Removing distortions to interest rates should be the primary focus of 'global' policy, but domestic concerns sometimes override this

The policy focus from a global perspective should be on raising interest and exchange rates that are too low at present. But domestic considerations in the countries concerned may delay this process.

This raises the issue of what else might be done to reduce financial risks (without unnecessarily restricting markets).

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Fees, securitisation and re-financing issues

Strong investor demand and pressure to find deals

With low rates, strong corporate profits and confidence in the economic outlook, pressure to find LBO deals is strong – as the capital available to private equity is accelerating (given the strong demand to invest in this asset class). Sponsors are likely to raise bids in order to win deals against other consortiums. This drives up stock multiples.

Up-front fee moral hazard

The up-front fee structure on the deals is a huge incentive – 2% of the total value of the deal is common, and can be higher, with 20% of the upside in performance fees to follow. Moral hazard may arise to get the deal done, and possibly to take on too much leverage, particularly when interest rates are distorted at too low levels.

Refinancing can be used to lock in investor profit of a successful LBO – this involves injecting more debt into the firm to pay dividends to equity holders. The removal of downside risk may come at the expense of a sustainable capital structure and risks to the ultimate solvency of the company in the exit phase. These problems may be compounded, if the manager becomes less focused on a company because the downside risk has been removed.

Fund manager refinancing to lock in profits and remove downside risk

Refinancing can also be used to avoid putting more capital at risk in an LBO that is not working well – a 'last roll of the dice', particularly if credit conditions are favourable. These activities build in a non-linearity – keeping a company going that should go bankrupt in good times and seeing it go under when interest rates rise.

Bank exuberance to get the deal done for fees and shift the risk via securitisation

On the financing side, deal sponsors approach different banks and brokers for initial underwriting and subsequent debt issuance. As this is a profitable fee-rich business, there is an incentive to give favourable terms to win the business. Banks typically hold the debt on their balance sheet for only a short period of time, and then securitise it in the debt markets, so the economic risk is transferred away. Banks may be less focused on 'kicking the tyres' and credit quality than getting the deal done. Risks may be under-priced as the search-for-yield-mechanism sees strong demand for debt instruments across the investor universe.

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Private equity principals often have strong relationships with investment banks, forcing partner banks to better deals on offer from competitors to protect relationships.

Policy issues

As deal multiples become more inflated the increased risk in deals is a policy concern. To the extent that domestic concerns in some countries will delay the removal of distortions to global financial price signals, there may be an urgent need for more risk assessment and stress testing within the private sector.

Need for better stress testing, given the low rate environment, before recommending buyouts to shareholders and staff

One important issue here is that the companies themselves need to be encouraged strongly to stress test debt exposures that might arise from an LBO bid before recommending any deals to shareholders. The board needs to fully understand what the interest cover might look like at more normal cost of capital levels. It also needs to explore the sensitivity of demand and supply circumstances in their industry to the potential impact of higher interest rates, oil prices, etc. over a full cycle. Shareholders and employees should demand this sort of due diligence.

Banks and rating agencies need to maintain strong credit checking processes

Similar issues arise for financial intermediaries. Banks need to ensure that credit standards remain high, regardless of the transfer of risk via the securitisation process. Credit rating agencies, too, need to ensure that high standards apply as this process becomes ever more complex.

Bank exposure stress testing is critical

There is a greater need for authorities to emphasise the need for stress testing: for direct balance sheet risks; for counterparty risks in the trading of LBO debt securities; and for crisis scenarios (including the potential for surprises in the interpretation of low covenant loans, etc., will behave in a credit event situation).

The previous LBO boom ended badly

The urgency of reducing the risk of major credit events at this stage of the cycle needs to be stressed. The late 1980s LBO boom ended badly. It reached its zenith with the giant RJR-Nabisco deal in 1989, a record USD 25 billion. That was a huge amount to absorb, and things slowed rapidly from then. The LBO'd retailer Campeau got into a liquidity crisis, and that triggered a fall in the market. In January 1990 RJR's debt was downgraded, and in

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February the lead underwriter in junk bonds, Drexel-Burnham-Lambert filed for bankruptcy. Spreads blew out, and the junk bond interest rate soared. Default rates rose, and large numbers of LBO companies were forced into negotiations with their creditors. The consequences for the economy were unpleasant to say the least.

IV. Issues concerning standards of practice

Inside information used to under-pay existing shareholders

Private equity has developed in part due to a desire to escape the rigors and attention of being listed on the share market and legislative constraints affecting remuneration (*e.g.* Sarbanes-Oxley in the United States). While this behaviour is consistent with market efficiency, questions do arise concerning the appropriate rules of the game. For example, it was remarked earlier that the returns from private equity have been very good indeed – and in a simple arithmetic example, without extreme assumptions, exit capital gains could be astoundingly strong. This could be due to the greater skill of the private equity managers. But it could also be due to relatively straightforward changes to the capital structure of the company, and operational changes that could be carried out by existing management for the benefit of existing shareholders (remember that most LBOs are friendly and keep top managers). In other words, the existing shareholders can be badly advised by their board, and underpaid for their assets, particularly in the early stage of an LBO cycle. This is most likely to occur if managers and the board are conflicted by equity incentives.

Inducements to directors/managers to recommend a bid – balance between commerciality and misuse of private information

It would seem to be inappropriate for private equity representatives to discuss equity rewards for key individuals and directors in exchange for recommending a buyout deal to shareholders – private information is kept back from the shareholders and broker company analysts prior to the announcement of a bid, and the moral hazard of personal return is introduced at an inappropriate stage. This is a transparency issue, where the right balance between commercial confidentiality and misuse of information needs to be achieved. Guidelines for fair and reasonable practice in this area would not hurt.

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Insider trading is common: share price movements and credit default swap shifts prior to the public announcement of a deal

The way the deals occur also mean that executives of the target company, their advisers, their bankers and other private equity firms approached get inside information about a bid and may deal in the share price. It is common to see share prices move well before a bid is announced. It is also interesting that there is less regulatory focus on the credit markets. It is very common to see credit default swaps move sharply before a deal is announced – clearly, if a private equity bid is coming, a large amount of debt will be issued in the company name with risks to ratings, etc. In some countries the requirements of the law to prosecute these cases are so demanding that little can be done.

Conflicts resulting from multiple activities

'Chinese wall' issues

Private equity fund managers typically commit their own capital to the pools of capital under their management, aligning their interests with partners. However the use of co-investment vehicles to make additional investments raises the risk that managers can cherry-pick more lucrative deals and allocate them to the funds in which they have greater exposure. Strong industry codes of practice are needed to avoid this sort of behaviour.

In some cases private equity funds run in-house hedge funds at the same time. It is unclear how 'Chinese walls' are or are not used in the potential transmission of information (*e.g.* credit quality of the debt, impending LBO deals, etc.). It is possible that the hedge fund could be used to warehouse debt that other investors did not want, to benefit the private equity fund at the expense of the hedge fund investors, or vice versa. Full transparency on this issue is required to ensure a level playing field.

These issues are raised to illustrate that the sector is unregulated in many jurisdictions and the absence of mark-to-market discipline means that appropriate governance relies on reputation alone over the longer run.

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Implicit 'puts'

Lender of last resort, deposit insurance, regulatory change comfort factors

Some sectors of the economy benefit from implicit 'puts' – that if something goes wrong, policy will adjust to avoid bankruptcy or other failures. Banks are a clear example, with lender-of-last-resort and deposit insurance.

Public utilities like gas, water and electricity may also evoke favourable regulatory responses if the alternative is a risk to the availability or quality of services.

In these cases there may be a distortion of deal flow due to the comfort factor provided by the nature of the industry, resulting in excess leverage.

Policy issues

Private equity is an alternative model to public companies that plays a unique role in helping transform companies and remove inefficiencies. The main differences are shown in Table 3.

Table 3. Summary of major differences of public versus private model

	Capital Structure	Ownership Structure	Operational Issues	Earnings Performance	Compensation Incentives	Corporate Governance
Public Co Model	*Low leverage tolerance	*Retail & insto mix, with low operating influence. *Pressure on instos to perform in s/run	*Continued investment to expand *Reluctance to major divestitures	*Market pressure to meet Qtly or 6-monthly performance	*Options gone post FAS 123 *More limited upside for management Intense public scrutiny	*Frequent investor meetings *Guidance to analysts *Relationships with analysts *Mark-to-market discipline
LBO Firm Model	*High leverage 5 to 8 x EBITDA	*Financial sponsors have major ownership & role in the business	*Stringent cost reduction *Sale of non-core assets	*Longer-term focus to max value for eventual exit from private model	*Significant ownership & upside potential for management. *No public reporting.	*Reduced pub. discl. *Analysts & investors can't get info. on deal *Fee structure & incentive moral hazard *Potential misuse of priv. information Refinancing profit lock in *Transfer of risk via debt and securitisation.

Source: OECD.

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There are numerous possibilities for conflicts of interest to emerge at the micro level. Strong self-regulation via cross-border industry codes of practice would help provide more transparency and avoid the misuse of private information.

A better ability to prosecute insider trading issues may also need further thought.

More focus on upside for the company than upside for managers

Rewards in private equity that are more focused on the upside at the exit stage, rather than on up-front fees and refinancing lock-ins of profit, would reduce conflicts of interest. The market is the best mechanism to do this, but the share market is not engaged to enforce discipline. Clear transparent and regular reporting to investors plays helps, enabling limited partners to have sufficient information to take action through the courts, if their interests are not being served.

Better cross-border guidelines for 'sound market practice' in private equity deal making could be a worthwhile exercise.

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