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Buyout Binge Is Sign of Good Health

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Handicapping whether the private equity buy-out binge is a fundamental long-term trend or one reaching bubble-like proportions has become a topic of discussion among market observers. That is no surprise, given the current leveraged buy-out boom – more than $280bn in US private equity deals were announced through May, triple the same period a year ago and accounting for 35 per cent of all merger and acquisition deals – has clearly underpinned the market's rise to record levels. If it is a bubble ready to pop, that could mean big trouble for share prices.

The private equity business is simple: using large amounts of debt, buy a company at a low multiple of cash flow, increase the cash flow and then exit at a substantially higher multiple. The combination of cash flow and multiple expansion, juiced by leverage, has produced spectacular returns, leading investors to pour more and more money into the sector, fuelling the record-breaking level of activity. As Warren Buffett pointed out at the recent Berkshire Hathaway annual meeting: "If you have a $20bn fund and get a 2 per cent fee, you're getting $400m a year. But you can't raise another fund with a straight face until you've invested it, so there's a great compulsion to invest it quickly so you can raise another fund and get more fees."

I should say up front that I am not at all a private equity basher. While some like to criticise private equity firms for taking short-term actions to "put lipstick on a pig" before quickly taking a company public, my general observation is the opposite. It is public companies that are more likely to sacrifice their long-term interests to meet the demands of short-term-oriented shareholders. In addition, I consider private equity owners to be far more likely to hire the right chief executive or remove an ineffective one when the situation warrants it.

Let us examine the pillars that have supported the private equity boom. The leverage pillar, in spite of recent increases in interest rates, is still largely intact. In a world awash with capital, lenders are willing to provide more and more debt financing, with fewer and fewer restrictive covenants.

Not surprisingly, private equity firms are taking advantage: according to JPMorgan, the ratio of average total debt divided by earnings before interest, taxes, depreciation and amortisation for the typical private equity deal has risen from 4.6 times in 2001 to 7.1 times in 2006 – and it's surely higher in 2007.

The other pillars of the boom are on less solid ground. Owing to increased competition and a rising stock market, the prices LBO firms are paying have risen dramatically: the average buy-out multiple has risen from 6.1 times enterprise value divided by ebitda in 2001 to 8.6 times last year – and, again, it's surely higher in 2007.

Thus one of the fundamental ways private equity firms have made money, buying at six times ebitda and exiting at nine times, has gone unless valuations continue to rise and stay high for many years to come, which is an unlikely prospect.

At the same time, opportunities to boost cash flows through better management and bolt-on acquisitions have also been diminished. Rising acquisition prices make bolt-on acquisitions a more costly way to increase cash flows. As for the upside from better execution, there is generally less low-hanging fruit among public companies than in the past. Thanks in part to increasingly active shareholders, it is harder for buyers to find companies that can be quickly improved by, for example, replacing the chief executive, shutting down unprofitable operations or investing in new growth areas.

At the very least, this state of affairs does not bode well for outsized private equity returns in future. Does that make it a bubble ready to pop? I do not think so.

Clearly, some bad deals have already been done and more will surely be done. But the more likely overall outcome is that the air slowly leaks from this bubble and the number of deals declines. There may be other calamities awaiting stock market investors, but I do not consider this to be one of them.

What are the implications for individual investors? It is possible, of course, to invest in a company with an expectation that it will be put in play and acquired.

We held on to our Wendy's stake, for example, even as the stock price rose from below $20 a share to about $30, in the belief that the activist investor Nelson Peltz would either fix Wendy's, buy it himself or engineer its acquisition by another investor – any of which would result in a stock price above $40. As it turns out, Wendy's on Monday said it was exploring a sale of the company and the stock has only recently pulled back from its high above $40 earlier this month.

In general, however, investors would be wise not to buy stocks based on the hope that they may be acquired for a higher price: this is usually greater fool investing and almost always ends badly. Just focus on identifying companies trading at large discounts to their intrinsic values and, if you are successful in doing so, you will be well rewarded whether the company is acquired or not.

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