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Special Report

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Thoughts on Private Equity Funds

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Successful investors tend to be good at anticipating future consensus and acting early to get positioned before the crowds start to fill the room. What separates good investors from great investors is timing.

Enter the Private Equity Market

One of today's biggest crowd-pleasers is private equity. The private equity market is grouped by its two main forms, venture capital and buyouts, although other variations exist including distressed debt and mezzanine financing. But it is the LBO market, the fastest growing segment, which has captured our attention.

The groundswell of interest in private equity stems from the perception that private equity managers can produce higher returns by exploiting market inefficiencies resulting from information advantages and the mis-pricing of non-traded, private enterprises. Astonishing flows of capital are pouring into private equity funds making these specialists, both new and old, the new torch bearers for alternative investing. According to Private Equity Intelligence's *2006 Global Fund Raising Review*, 479 new funds raised $261 billion in 2005, an all-time record. In just one year private equity raised about one-quarter of the total size of the hedge fund industry.

Buyout funds raised about one-half of this capital, or $134 billion, and a majority ($78 billion or 60%) was gathered by 17 so-called mega funds capable of big LBOs. Well-known firms like Blackstone, Bain Capital, and KKR are headlining the capital raising and deal making. The table below highlights the largest LBOs in history; 7 of the 10 biggest took place in 2005. The remaining deals on the list took place in the 1980's when names like Michael Milken and Ivan Boesky were legendary, greed was good, and portfolio insurance was the future.

The private equity fund raising trend continues in 2006 at an unprecedented pace. Whether these new capital flows generate the massive gains expected by this investor base is unknown and will remain so for some time. Meanwhile, the corporate bond market has immediate exposure to LBO event risk. Thanks to the extent CDS has developed in recent years, bondholders not only have an adequate means to protect themselves, but one of the best speculative instruments available to beat private equity players at their own game.

Largest Leverage Buy Outs in History

Date Announced	Target Name	Country	Market Sector	Acquirer	Value of Deal $Bins
Oct-88	RJR Nabisco	US	Consumer	KKR	$29.4
Nov-05	TDC (Teledanmark)	Denmark	Telecom	KKR, Apax, Blackstone, others	$15.7
May-05	Wind Telecomunicazioni	Italy	Telecom	Sawiris, Ross, & Nguyen	$12.8
Feb-05	Seibu Railway Co	Japan	Transport	M&A Consulting	$11.3
Mar-05	SunGard Data Systems	US	Technology	KKR, Silver Lake	$10.8
Oct-85	Beatrice Companies	US	Consumer	BCI Holdings Corp	$8.2
May-05	Viterra	Germany	Real Estate	Terra Firma	$7.1
Jul-89	Elders IXL	Australia	Consumer	Harlin Holdings	$6.3
Mar-05	Toys "R" Us	US	Consumer	Bain, KKR, Vornado	$6.1
Mar-05	Amadeus Global Travel	Spain	Travel	Cinven, BC Partners	$5.8

Source: Thomson Financial
2005 Deals Highlighted In Red

Is Private Equity More Profitable?

Private equity performance is nearly impossible to illustrate with confidence. An accurate measure of private equity's past results makes the biases associated with hedge fund index measurement look like child's play. A fair evaluation of a non-public business is anyone's guess. Unlike investing in public companies, realizing profits in private equity requires nurturing, several rounds of re-capitalization and long lead times. The J-curve describes the 20% to 40% drop in value that private equity investments usually incur during the first three years of the investment before the value takes off. Bringing a company to market through an initial public offering or divesting of a private business via a sale to an existing public entity takes anywhere from 5 to 12 years and is loaded with uncertainty. A business' prospects and the climate for IPOs evolve over time and not always favorably. Given the multi-year lead times to realizing potential gains, private equity tends to be the least transparent and most illiquid category of investing available to mankind.

In fact, we have had difficulty reconciling whether the average private equity investor has done better than owners of public stocks. Thomson Venture Economics provides figures of historic returns using pools of private equity funds formed during blocks of five years beginning in 1984. Performance is calculated using a compounded internal rate of return (IRR) method over 10-, 15- and 20-years. According to Thomson's figures, buyout funds appear to perform better than venture capital funds. Buyout's 10-year IRR equaled 12.5% per annum. The S&P 400 mid-cap index, by comparison, generated an annual return of 13.7% over a similar period. Similarly, the S&P 600 small cap index returned 12.3% per annum. Figures for private equity over the longest series available, 20 years, provide a similar conclusion – private equity performance is no better than established, liquid mid-sized publicly traded companies.

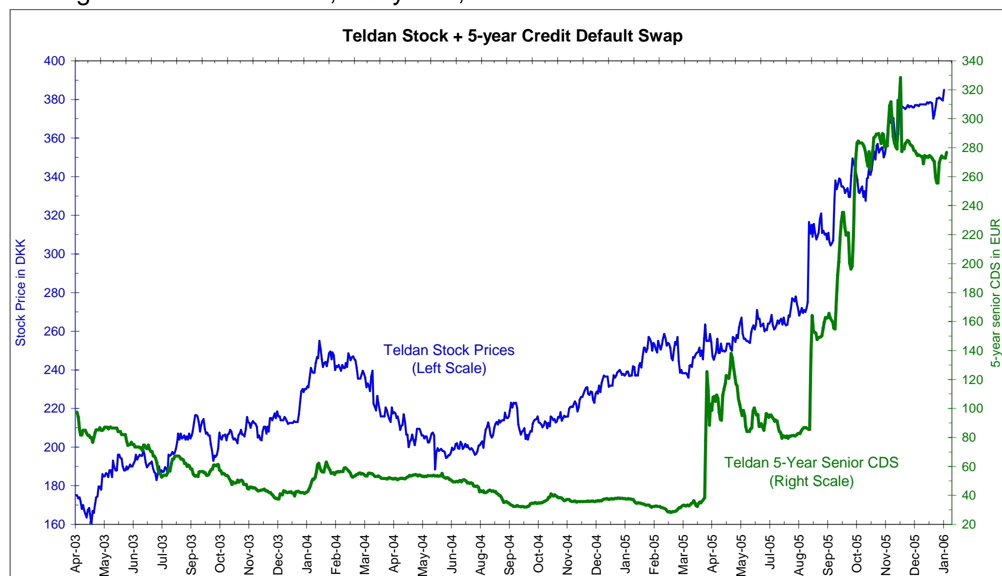
Should Private Equity Concern Bond Investors?

Equity markets benefit from a lively LBO climate. The potential for LBOs underscores the attractive characteristics of capital structures and cash flow in the sectors in play. While attractive for stocks, an LBO is a corporate bondholder's worst nightmare.

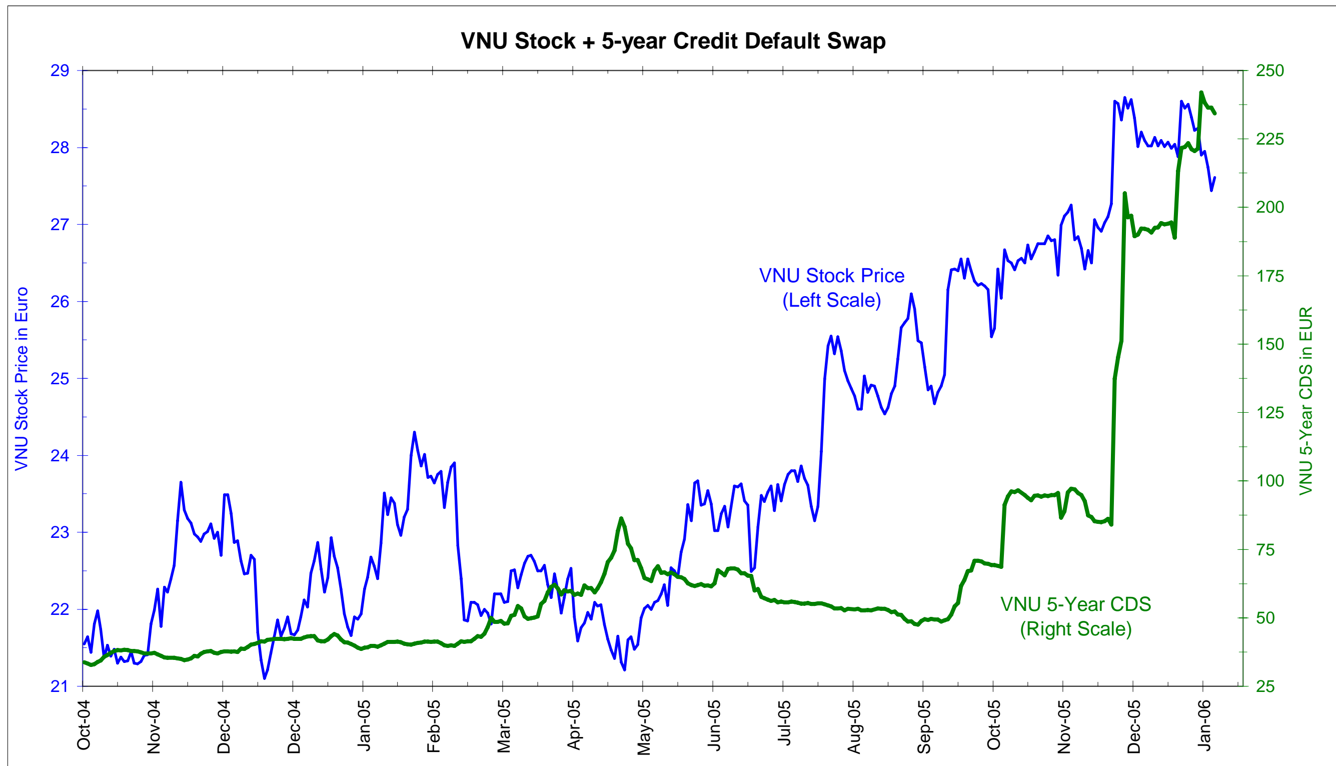
Corporate bonds are priced based on the creditworthiness of the issuer as a spread above equivalent swaps or sovereign debt. These spreads widen or narrow as the perception of risk changes. In the case of an LBO, a pile of additional debt plus a little equity is used to affect the buyout and is added to the capital structure, straddling the company with the burdens of heavy interest expense. This reduces capital ratios down to the levels normally classified by rating agencies as "junk." Reaction in the debt and Credit Default Swap (CDS) markets can be instantaneous and violent. Yesterday's single-A credit is today's single-B leveraged buyout candidate with all the trimmings, including a tripling of the credit spread and a lack of bids.

To illustrate market reaction to an LBO event, the following graph shows the stock and CDS price reaction to world's 2nd biggest ever LBO - Denmark's telecommunications company Teldan.

Teldan was bought by a consortium of five private equity firms in a deal made public in November 2005. Last year, Teldan's stock price rose 73% while the price of 5-year credit default protection (CDS) jumped from 25 basis points (bps) to 280 bps – an 11-fold increase.



Similarly the below example shows Dutch publisher VNU's stock and CDS price reaction following the takeover offer from a consortium of seven large buyout firms in January. In this case, the stock price rose some 30% while the cost of CDS protection jumped 200 bps or some 400%.



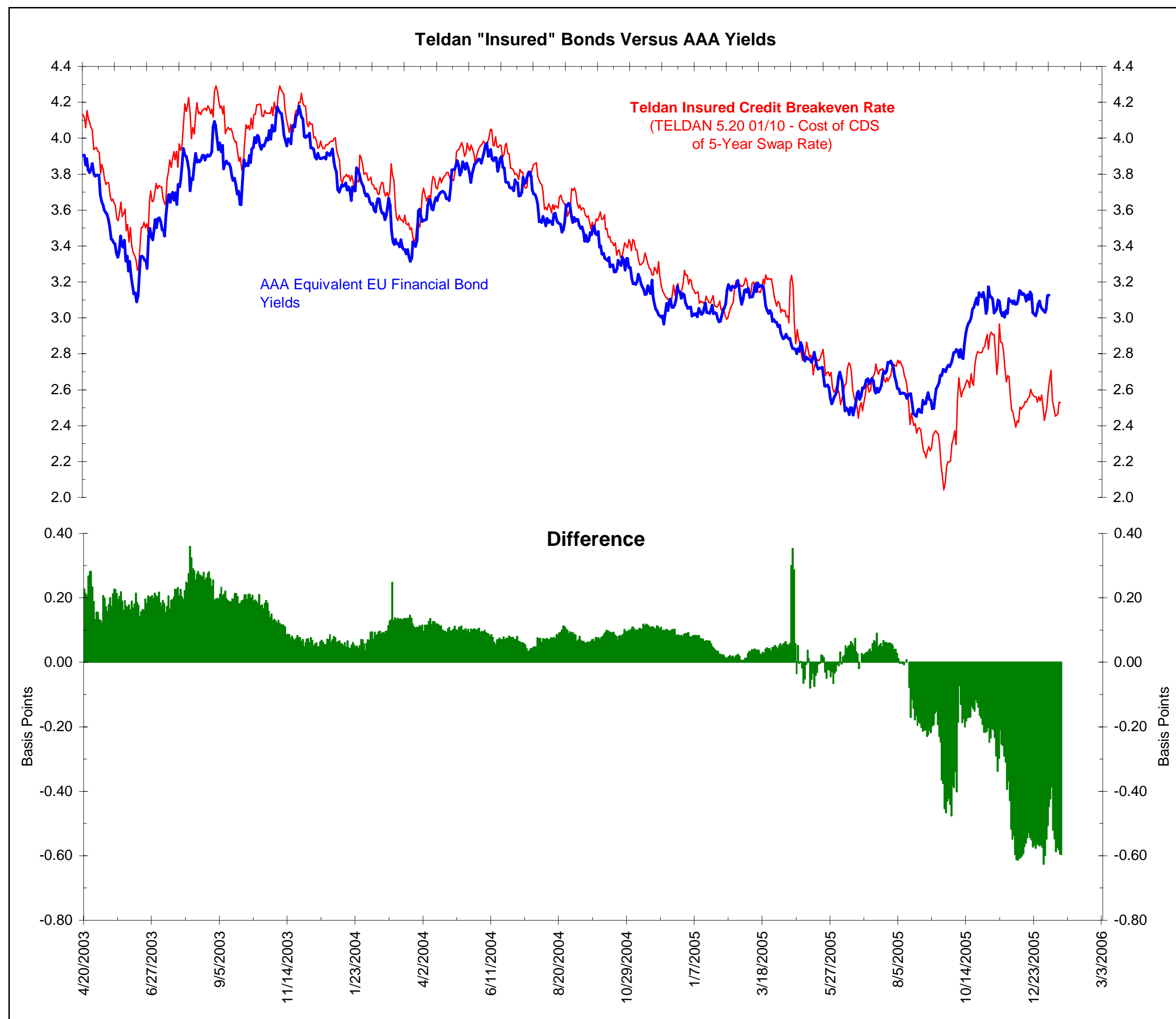
Since only well-run, solid businesses can absorb the extra debt burden, the companies most likely to be put "in play" by private equity consortiums are of investment grade quality. For credit portfolio managers and analysts, this adds a new and challenging twist to corporate bond selection. Managers with investment grade mandates suddenly are obliged to have exposure to levels of event risk unlike anything witnessed in years.

Do Credit Default Swaps Provide Adequate Protection Against Event Risk?

CDS's provide insurance protection against a "credit event" which includes bankruptcy and other triggers but *not* an LBO. However, the price of a CDS is a function of the **likelihood** of a company triggering a credit event, and an LBO brings a company quite a distance towards the threshold of default. Since corporate bonds are relatively illiquid securities, CDS provide a more liquid way of insuring against event risk. But do they work?

The cost of owning debt with CDS protection normally equals the yield of an equivalent maturity fixed-rate swap. This is known as the "insured breakeven rate." When the insured breakeven rate less the maturity equivalent swap rate trades **above** zero, CDS protection trades at a discount. Likewise, when the insured breakeven rate less the equivalent swap trades **below** zero CDS protection trades at a premium.

The graph on the next page illustrates this point. Teldan CDS protection moved from discount to premium in August as word of the impending LBO became public. **Those investors who owned CDS protection before the deal was announced were provided with more than 100% compensation for the drop in price of their bonds.** Today, CDS protection for Teldan trades expensive vs. the debt and would only be worth holding if the investor believes default is imminent.



Conclusion

Investors from around the globe are pouring capital into private equity at an unprecedented rate, making private equity the current choice among "alternative" investments. The bulk of this capital is flowing into the hands of a few so-called mega funds that have succeeded in pooling resources and capital, creating a string of some of the largest deals on record. The trend of consortium buyouts may intensify as hedge funds extend lock-ups and apply side pocket provisions to move into private equity, creating new deal-making competition. Today, no public company is completely out of the reach of an LBO.

How long does this party last? People thought the LBO craze of the 1980s would end in 1987, the year Drexel paid Michael Milken $500 million, but it continued until the failed United Airlines takeover in October 1989. The same is likely to occur again this time – it goes on until it breaks. Today, the market remains turbocharged with ample liquidity, low financing costs, and mandates from performance-thirsty limited partners. Without access to the credit default swap market and the adequate protection it has provided against event risk, this could have spelled trouble for bondholders.

Managed corporate bond portfolios will continue to have their work cut out for them as they maneuver through a minefield of event risk, but **the good news is that recent deals have shown that CDS can provide more than adequate protection through the event.** Buying CDS protection for a position trading at a premium to comparable swaps however is, effectively, hedging against bankruptcy, not event risk, and in such a case it is more effective to just sell the underlying.

Recent deals have also illustrated that outright long CDS positions provide multiples of the returns provided by stocks and options without the cost of carry or time decay. Now investors have an instrument which provides both adequate protection against event risk and an effective way to beat private equity players at their own game.

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