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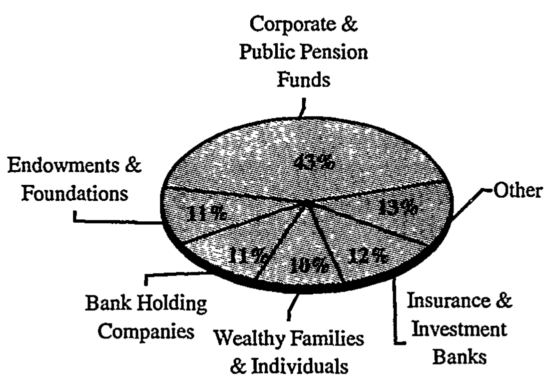
COMMENT: LEVERAGED BUYOUT FUNDS AS A POINT OF COMPARISON

John G. Nestor†

I am John Nestor, a managing partner with Kirtland Capital Partners and the only non-lawyer speaking today. This morning I have been asked to make comments on the talk that John McIlwraith has just given. John and I worked together in 1986 when I joined Kirtland Capital and John was at Jones Day. In fact, he helped me with the first deal I did at Kirtland, and no doubt, I contributed to some of his gray hairs.

Figure 1

Sources of Equity Finance



Source: Federal Reserve

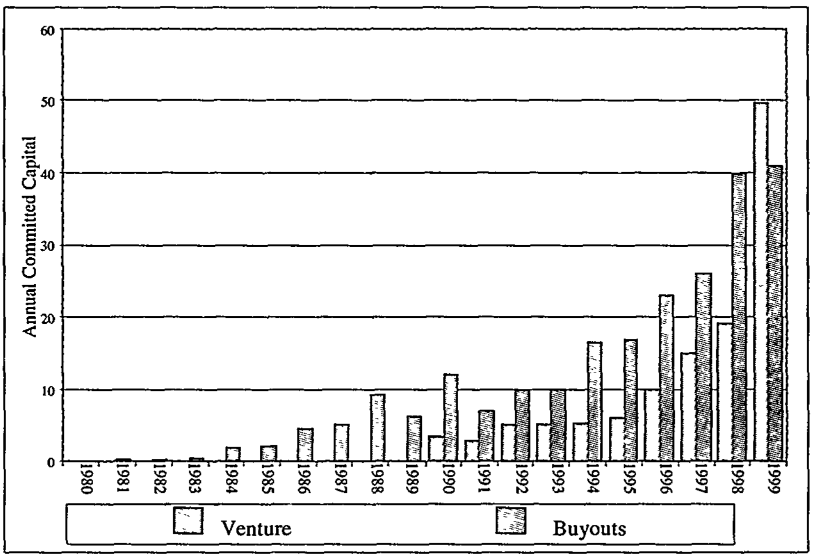
† Managing Partner, Kirtland Capital Partners, Willoughby Hills, Ohio.

To begin with, I would like to talk about private equity and where it comes from. Private equity includes both money for venture funds and for leveraged buyout ("LBO") groups. Approximately 43% of private equity is derived from corporate and public pension funds. The balance is split up almost equally among endowments and foundations, bank holding companies, wealthy families and individuals, insurance and investment banks and another 13% from various sources.

Figure 2 shows the amount of committed capital that went into venture and buyout investments from the period 1980 to 1991. While starting at very low amounts in the early 1980s, it gradually increased and reached record levels in 1999, which most likely will be exceeded in 2000. These investments and the activity in venture and buyout funds has been fueled by the large amount of money made available through them, particularly from pension funds which have had to find ways to invest the increasing amount of money they are managing.

Figure 2

U.S. Venture and Buyouts Investments

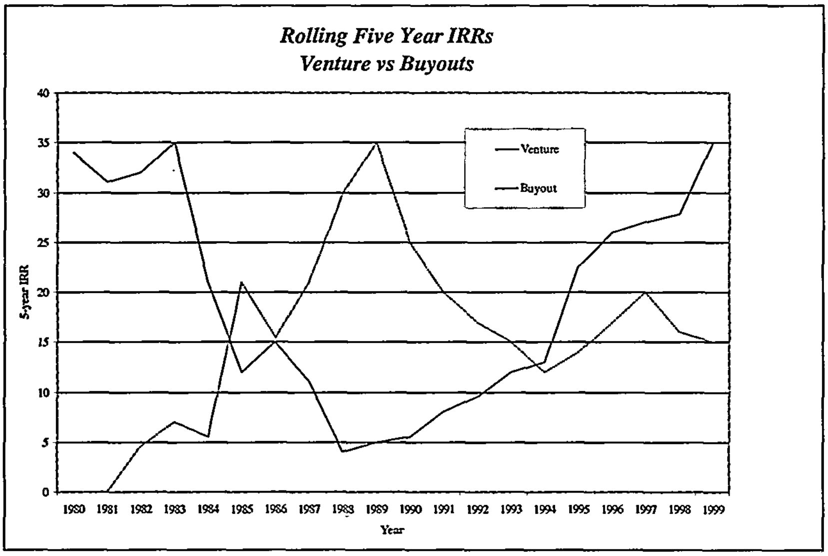


Sources: *Venture Economics*/NVCA.

As you can see in 1999, the amount of committed capital going into venture funds exceeded that for buyout funds for the first time. The reason is very simple. The return on venture funds exceeded that of the buyout funds beginning in 1994. Figure 3 illustrates this. All of this was a direct result of the funds being invested in the venture firms that were backing all of the high-tech companies that we have all read about. With some of the recent setbacks in the stock market, the return on some of these venture funds may, in fact, also come down.

Figure 3

Fund Returns



Sources: *Venture Economics*/NVCA. -

What I was asked to do this morning was to comment on John McIlwraith's talk, which I have now done. I am going to follow the lead of Al Gore and George Bush during the televised debates in which they would initially and very quickly answer the question that they were asked, and then go off and talk about what they would like. So with that in mind, I fulfilled my obligation and now I would like to spend the rest of my time talking about LBO funds and contrast those investments with the venture funds that John talked about. Someone once told me that to give a successful presentation, you do not have to be witty and stimulating and provide the audience with a lot of facts, but rather you have to give the audience good news. I do have good news, but you are going to have to wait until the end of my talk to hear it. So for the next ten minutes I will try to be witty and stimulating, keep your attention, provide a lot of facts and figures, and tell you where I think the LBO industry has been and where it will go in the future.

LBOs have developed over time and have undergone various phases. Phase I began in the 1970s. In the mid- to late 1970s a number of people, including my partner Jack Turben, who started Kirtland

Capital in 1977, realized that if you found a company that had a lot of assets, you could purchase the company by going to a bank which would lend against the assets. To complete the deal, you could put in a little equity. Because of the small equity base, you could get very good returns just by paying down debt. There were a few companies who did this very well, including one organized by three gentlemen by the name of Kohlberg, Kravis & Roberts, who did it in increasingly larger deals. Typically, the target companies were mostly privately held and there was little competition because there were very few firms doing this.

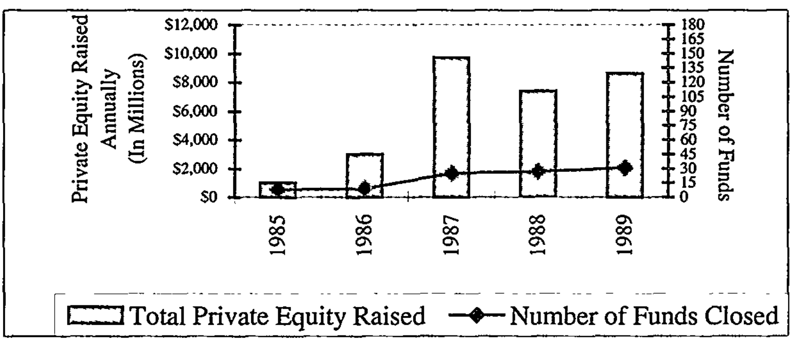
Phase II encompassed most of the 1980s, with LBOs gaining increasing popularity and developing into almost a frenzy by the late 1980s. The biggest difference during this period was a result of Michael Milken's development of junk bonds or high-yield bonds as a way to finance LBOs. This stimulated the whole industry and made it much easier to acquire larger and larger companies with public companies becoming the target of LBO firms.

During the 1970s and 1980s, many conglomerates had been put together, but some did not yield the synergies or earnings that had been intended. As a result, a corporate raider or an LBO firm could go in, take the company private, cut people and costs, sell assets and pay down debt, and generate very significant returns. In many cases the parts were worth more than the whole company.

During this period, the LBO industry became more structured with funds being raised for the express purpose of doing LBOs. The number of firms involved was still relatively small, as shown in Figure 4, and the dollars raised were modest compared to today's funds.

Figure 4

Equity Capital Raising

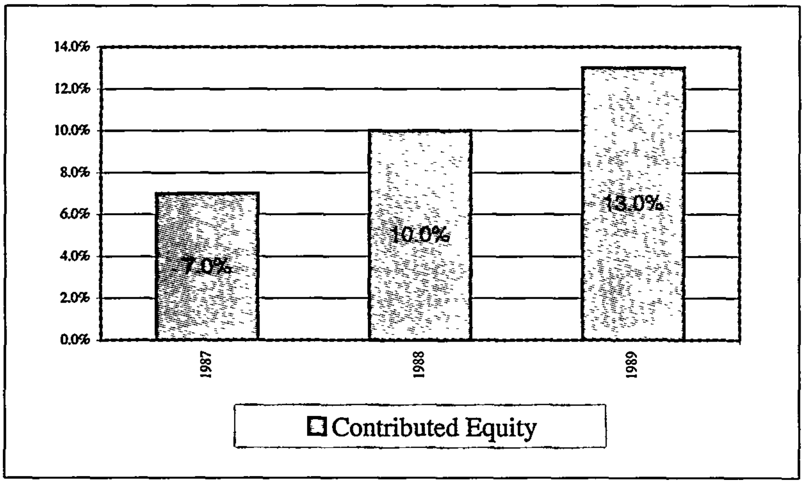


Source: *Buyouts*, *Private Equity Analyst*.

This was a result of the fact that transactions were still very highly leveraged. Figure 5 shows that in 1987 you could put in as little as 7% in equity and finance the rest. By 1989, this had almost doubled to 13%, but still represented very little equity required to complete a transaction.

Figure 5

Equity as a Percentage of LBO Financings

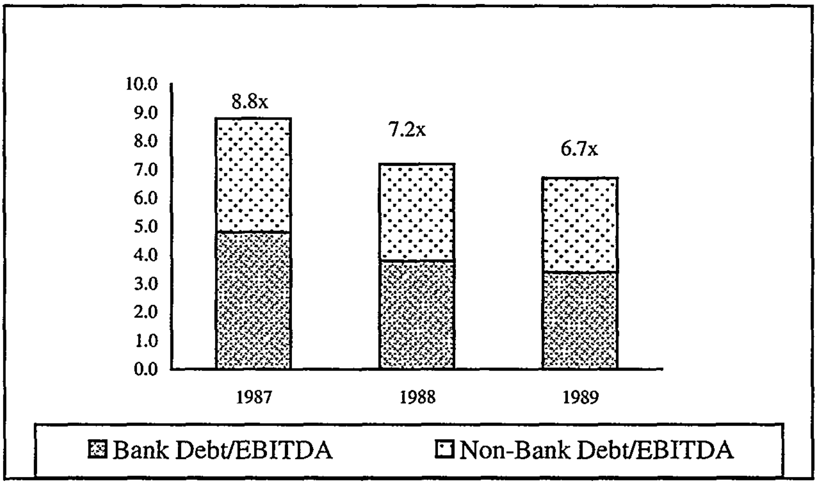


Sources: Portfolio Management Data LLC, *Buyouts Straight Talk.*

Figure 6 illustrates the amount of leverage in these transactions. Bank debt to EBITDA averaged almost five times in 1987. It was still almost 3.5 times in 1989. In addition, transactions were also funded with non-bank debt, which took total leverage on average in 1987 to 8.8 times and 6.7 times in 1989. These are very high multiples and contrast very significantly from what is happening in today's market, which you will see later.

Figure 6

Average Debt Multiples of Highly Leveraged Loans



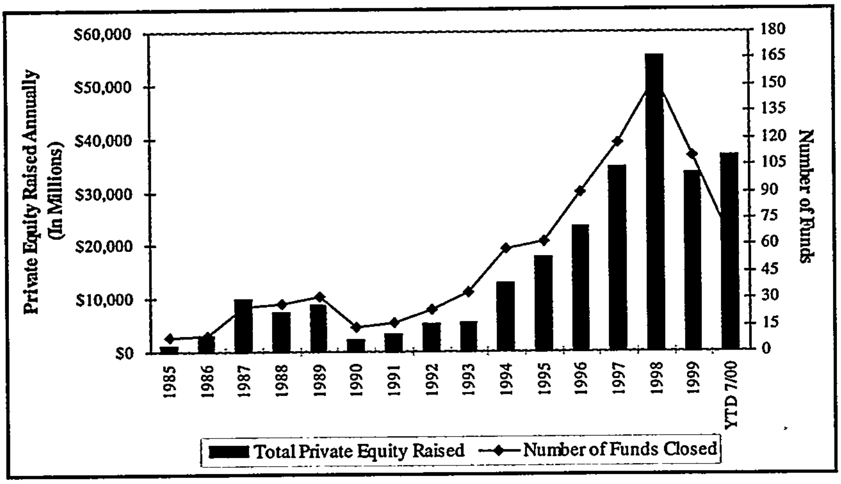
Source: PMD Loan Stats.

The next phase was in the 1990s, which can be divided into two phases. In the early 1990s, buyouts slowed because of the problems in the high-yield and bank markets and the slow down in the economy. Because the transactions done in the late 1980s were so highly leveraged, when the economy slowed down there were many defaults in both bank loans and junk bonds, resulting in a period when very few transactions were completed.

The mid- and late 1990s reflected a turnaround in LBO activity fueled by a better economy and a large amount of capital available to buyout funds and a proliferation of new buyout groups. Figure 7 shows the history of total equity raised and, as you can see, it reached a peak in 1998 totaling almost $55 billion. While the final numbers in 2000 are not yet in, it is likely to be close to the record set in 1998. The number of funds closed also reached new highs in the late 1990s. It is now estimated that there are over 800 LBO firms, which resulted in too many dollars chasing too few deals. This has caused the returns of LBO groups to go down, which was illustrated in one of the earlier charts.

Figure 7

Strong Equity Capital Raising

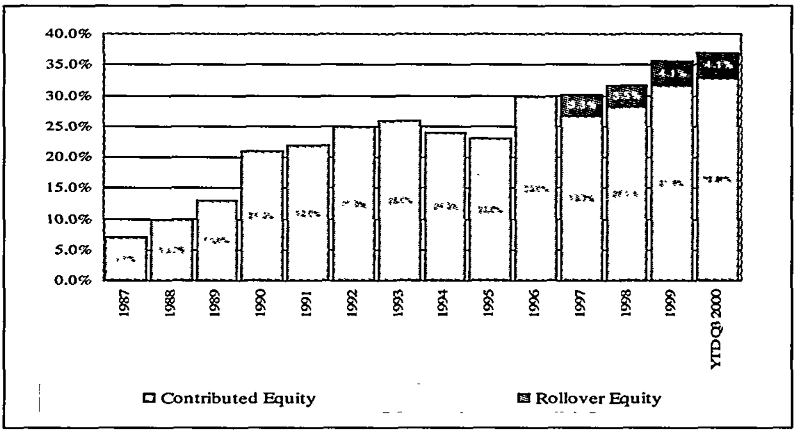


Source: *Buyouts, Private Equity Analyst.*

Because of the competition and the amount of money available, the focus of LBOs has changed. There have been more international deals done; some funds have been specifically raised to do international transactions. Many LBO firms have tried to do roll-ups in an industry where they invest in one company and try to make acquisitions of similar type companies. We have seen roll-ups in everything from candy stores to funeral parlors.

One change has been the requirement by the banks to put in larger equity contributions, which has also held down returns. Figure 8 shows the increasing amount of equity required as compared to 1987.

Figure 8
Strong Equity Component: Equity as a Percentage of LBO Financings



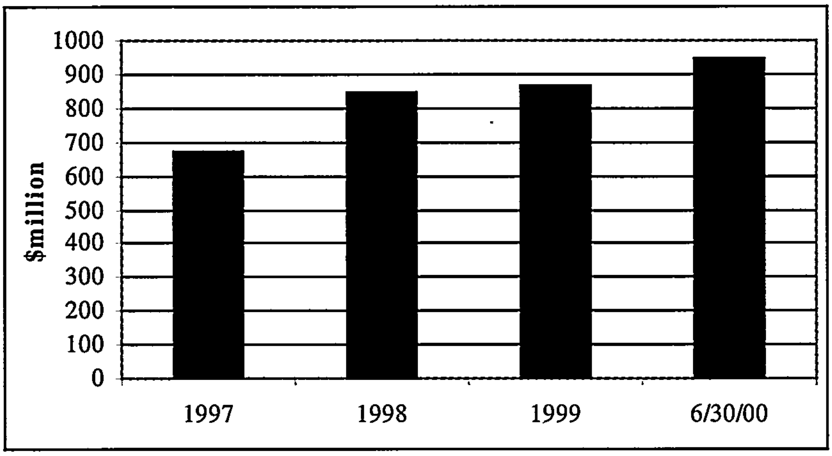
Sources: Portfolio Management Data LLC, *Buyouts Straight Talk.*

The other competitive factor for LBOs has been the IPO market. An increasing number of companies have turned to the IPO market for liquidity as opposed to being bought out by LBO funds.

That now brings us up to the present and what we are seeing in 2000, which appears to be yet another phase. The most significant development has been in the lending market, both the banks and high yield. The banks increasingly have had portfolio problems and the amount of non-performing assets, as shown in Figure 9, has increased dramatically. At the same time, the number of corporate debt defaults, shown in Figure 10, has also increased dramatically. As a result, it is much harder to complete a transaction because of the tighter credit markets than in the past. This problem has been exacerbated by the decreasing number of banks due to consolidation. Figure 11 illustrates this.

Figure 9

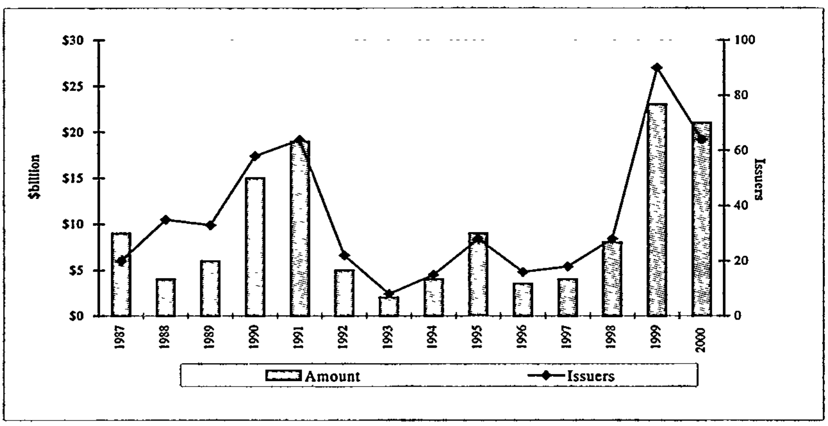
Nonperforming Assets at the Top Twenty Banks



Source: Public Filings.

Figure 10

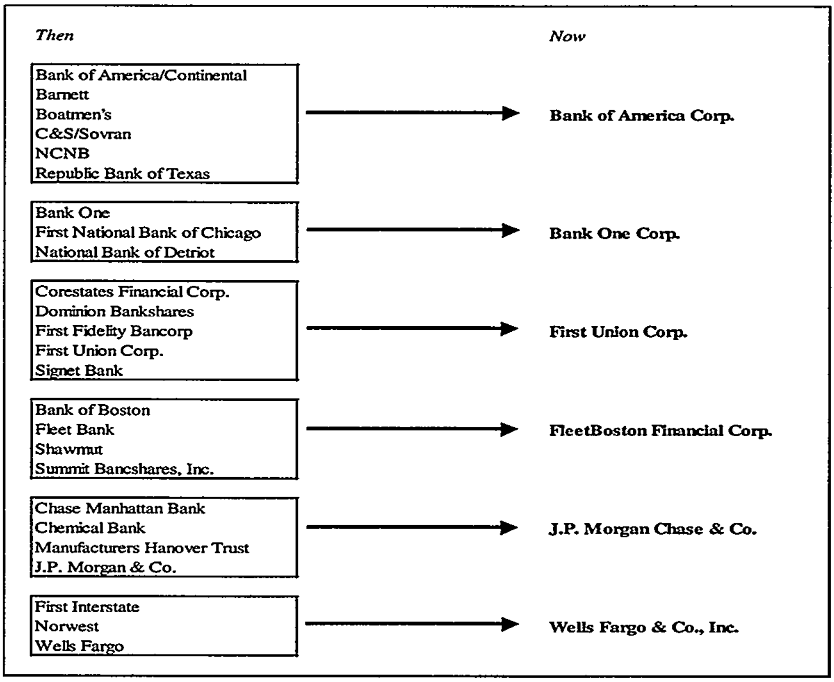
Defaults on Public Debt



Source: Standard & Poor's Global Fixed Income Research.

Figure 11

Impact of Bank Consolidation

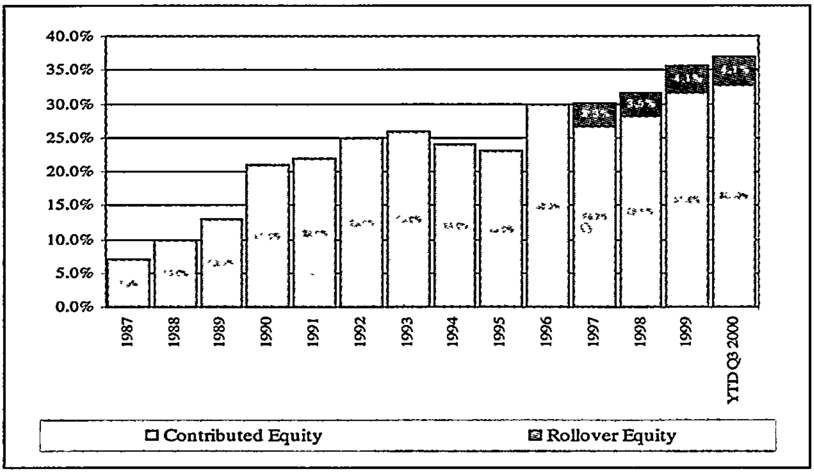


Source: First Union Securities.

Over the last eight years, twenty-six very large banks, most of which had been active in financing LBOs, have been bought or merged into six. Many of those on the list are currently having credit problems, which has made the market even tighter.

Because of the tight credit markets, LBO firms have been forced to put in increasingly high levels of equity to get a bank to finance any of their transactions. This is illustrated in Figure 12.

Figure 12
Strong Equity Component: Equity as a Percentage of LBO Financings



Sources: Portfolio Management Data LLC, *Buyouts Straight Talk.*

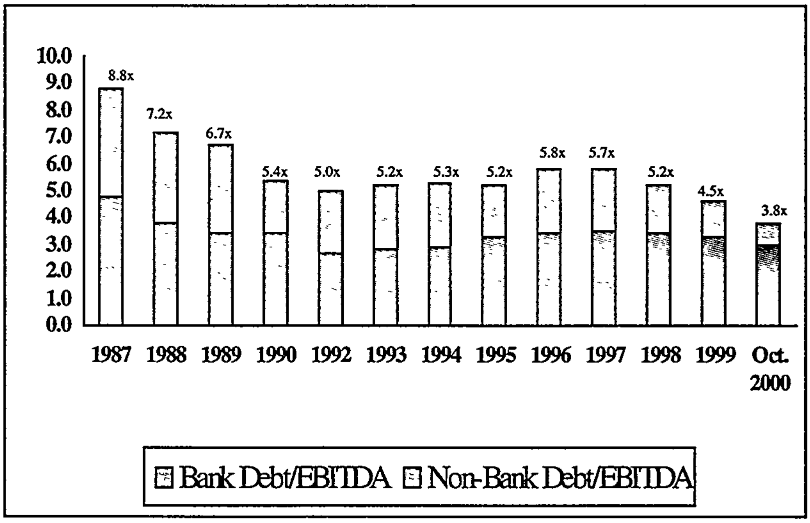
Earlier, I talked about how much leverage banks were willing to allow in transactions in the late 1980s and, as you can see from Figure 13, they have become increasingly conservative over the last couple of years, and particularly during 2000. I think we can expect this to continue through 2001. Another interesting development has been the slowdown in the number of IPOs. There have been some dramatic peaks and valleys in that market, and it is likely we will see that again as the stock market comes down to earth. This should result, over a period of time, in an increase in the use of LBOs, as the IPO market is likely to diminish.

The question now is, what happens to LBOs in the future? As many of you know, law firms have been very instrumental in the growth of the IPO market and have in turn grown significantly because of the amount of legal expense it takes to complete a transaction. I think that because of the changing nature of the industry, there will be an increasing need for legal help. More and more firms are completing international transactions, which require assistance in understanding the legal requirements in other countries. Many firms are considering minority ownership in the companies they are buying or are looking to buy businesses with other LBO groups. This requires more complicated shareholder agreements.

A more challenging financing environment requires more creativity in terms of financing. Because of the declining stock market, there are more likely to be public companies going private, which requires additional legal expertise. The fading IPO market will result in more activity for LBOs, but it is likely that there will continue to be pressure on lower returns. With less room for error, this means that there will be more emphasis on due diligence.

Figure 13

Average Debt Multiples of Highly Leveraged Loans



Source: PMD Loan Stats.

The conclusion from all of this is that there will still be a very vibrant LBO market, although changed from what we saw in the 1980s and 1990s. It will continue to be very competitive. Returns are not likely to be at the levels that they were in the 1980s, but they will still be attractive.

And what does this all mean for the legal community? It means that LBO firms will need more legal help with due diligence, an understanding of international laws, more time spent with the financing side of transactions, the intricacies of public companies going private, more shareholder issues and the need for speed and help with structuring and tax planning. In turn this leads to more billable hours, which is the good news that I promised.