**The Big Read** **Private equity**

# Private equity: flood of cash triggers buyout bubble fears

The buyout sector is on a tear as investors hunt for higher returns. But some fear a dangerous new cycle

Javier Espinoza in London
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The investment industry usually operates on a simple piece of logic: money managers pitch to their clients and persuade them to stump up cash. But when CVC Capital Partners, the private equity group best known for the 2005 takeover of Formula One, set out to raise a new fund last year, the investors were the ones begging to gain access.

Europe's largest buyout fund rented some 20 rooms at the Savoy Hotel in central London at the start of last year as investors pressed the flesh with senior managers. Treated more like celebrities than investment managers, CVC's star dealmakers were on display for investors wishing to buy into the heavily oversubscribed fund.

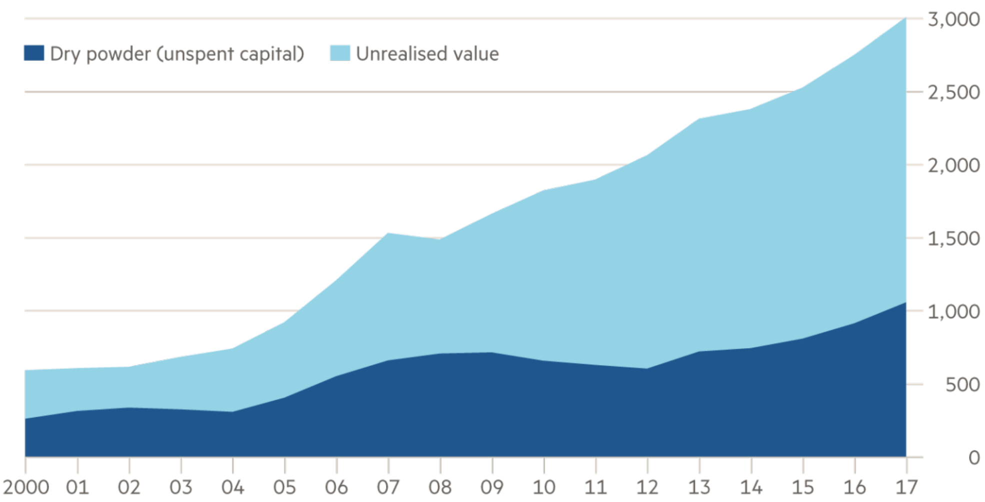
"Every 45 minutes we would swap over," says a long-time investor in CVC funds, each time meeting a different executive in the hope that they would let them in their fund. "We make sure managers like us and keep us. It's hard to get [our] money in the door these days."

It is an indication of the feverish conditions in private equity that buyout groups are not only setting new records for fundraising, they are also turning money away at their fastest ever rate.

CVC identified demand of €25bn-€30bn from investors while raising its new €16bn fund last year: more recently Bridgepoint, the private equity owner of Pret A Manger and Fat Face, turned away €5bn, according to people familiar with the fundraisings. Others are yielding to the temptation to take on more cash than expected: Partners Group had been expected to raise a new €2bn fund, but ended up with €6bn to invest.

## A wall of cash reserves creates pressure to spend

Private equity assets under management ($bn)




Source: Preqin
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The buyout industry is on a tear. Funds are raising more money than they can spend, fuelled by low interest rates on other asset classes. Buyout volumes were up 27 per cent year on year in 2017, according to Thomson Reuters, and are expected to accelerate this year, propelled by a record $1.1tn of cash pledged by investors last year.

But barely a decade after the financial crisis, these are also alarming signs that the boom in the private equity sector could turn to bust — including aggressive and rapid dealmaking that leads to soaring prices for companies. The size of recent deals has surpassed those pre-crisis peaks and dependence on debt financing is nearing record levels. A decade ago, a string of buyout firms went out of business after a period of similarly frenzied activity.

"It is quite amazing that there is no collective memory that goes beyond five years, or that the world is organised in such a way that history keeps on repeating," says Ludovic Phalippou, a finance professor at the University of Oxford's Saïd Business School, and the author of *Private Equity Laid Bare*. "Why would this time be any different?"

**Notable mega deals of** the past 12 months include the $18bn agreed sale of Toshiba's memory chip division in Asia to a consortium led by Bain Capital, which is currently going through an antitrust approval process, and the $6.9bn acquisition of office supplier Staples by Sycamore Partners in the US.

The prices being paid are in some cases well over the multiples being paid a decade ago. One of the most expensive deals last year was the $5.3bn purchase of Nets A/S, Scandinavia's biggest payments processor, by Hellman & Friedman, which was a roughly 30 per cent premium to the share price before there was speculation over a deal, or 24 times net income. The price tag was so high that it led to H&F co-chief executive Patrick Healy issuing a warning about valuations. "Any time you buy something today [it] is at the highest price," Mr Healy said following the acquisition.


Already the auction of Akzo Nobel's €8bn-€12bn specialty chemicals division has attracted fierce competition from private equity firms clubbing together, including one group consisting of Advent International and Bain Capital. CVC and KKR were interested but have dropped out of the race because of concerns about the deal being too expensive, according to people familiar with the process.

"The private equity fundraising environment has been extraordinary," says Alison Mass, global head of the financial and strategic investors group at Goldman Sachs. Some of the largest names are likely to pursue a string of multibillion-dollar transactions early this year. "We are in frequent dialogue with our largest clients regarding targets in excess of $10bn," says Ms Mass, who has advised the largest funds on multibillion-dollar deals over three decades. "To the extent such a seller exists, the appetite and capital are there."

David Rubenstein, co-founder and co-executive chairman of the Carlyle Group, insists firms like his can still 'have an edge' when asset valuations are high © Bloomberg

The biggest drivers of today's buyout boom are the same ones that fuelled the sector before 2008: cheap debt and a huge wall of cash. The massive rounds of bond-buying by central banks, which have kept rates down, have also given a powerful boost to private equity. For buyout firms, the cheapness of debt is a crucial tool to increase leverage and do ever larger deals. At the same time, big investors such as pension funds and sovereign wealth funds are desperate to find a home for their cash that can outperform lacklustre bond yields.

**The flood of money** into the sector means that it now represents a mainstream asset class with $3tn in assets under management, according to data provider Preqin. In the US alone, there are roughly 7,500 private equity-owned companies, employing 11m people. In the UK there are 2,980.

Leveraged Commentary & Data, a unit of S&P Global, reported one of the busiest Decembers on record in Europe for leveraged loan issuance and it has predicted there will be no "dry January" as there often is in the new-year period, so jammed is the pipeline of deals waiting to get done.

"These are unashamedly incredibly attractive conditions to borrow money," says a capital markets specialist at a large private equity group. "Will that debt be available to buyers in five years' time? Probably not. Buyout groups are bullish to take the risk in 2018. It's a risk-on environment."

From CVC Capital Partners' new fund in Europe to Apollo Global Management's $25bn fund in the US, large buyout funds are amassing enormous firepower and are set to attract even more capital in decades to come. At the other end of the market, a record 770 first-time private equity funds are currently seeking capital, according to Palico, an online marketplace for funds. That is 48 per cent more than the previous all-time high of 520 in 2008.

## Signs of a private equity boom


Bain Capital is leading the $18bn deal for Toshiba's memory chips division, subject to regulatory approval © Bloomberg

**>€25bn**

Demand identified from investors by CVC for its new €16bn fund last year

**27%**

Rise in annual buyout volumes in 2017, with $1.1tn pledged by investors

**770**

New private equity funds seeking capital, 48% up on the previous record in 2008

"The fundraising environment is very robust," says Michael Wolitzer, head of the investment funds practice at Simpson Thacher & Bartlett in New York.

Yet despite the buoyant conditions, there are plenty of echoes of the calamitous investments from the boom that preceded the crisis. The aggressiveness of deals struck just before 2008 overloaded many portfolio companies with debt that backfired for buyout firms.

A string of private equity groups — from Candover in the UK to Hicks Muse, Tate & Furst in the US — collapsed in the aftermath of 2008 in part under the weight of their own unmanageable debt and poorly-executed deals.

Jon Moulton, the veteran turnround investor, says: "I estimate 20 per cent of buyouts had problems with their debt finance during the crash."

One of the most potent symbols of the sector's effervescence is the revival of Terra Firma, the fund founded by Guy Hands, above, which is seeking to raise $3.4bn from investors © Bloomberg

No one is currently predicting a freeze in debt markets as happened a decade ago, but a prospective increase in interest rates is a concern, says Mr Moulton. "The coming rise in interest rates will inevitably give rise to more problems, and sometimes collapses, of highly leveraged private equity structures."

The wave of money might make it easier for managers to raise new funds, but the extra competition also makes it harder to find attractively priced companies to invest in — just like a decade ago. The levels of leverage used in US buyouts are nearing the peaks seen before the crisis, with debt 5.8 times a target company's earnings in transactions last year, according to LCD, a unit of S&P Global Market Intelligence. That's just shy of the multiples of 6.2 seen in 2007.

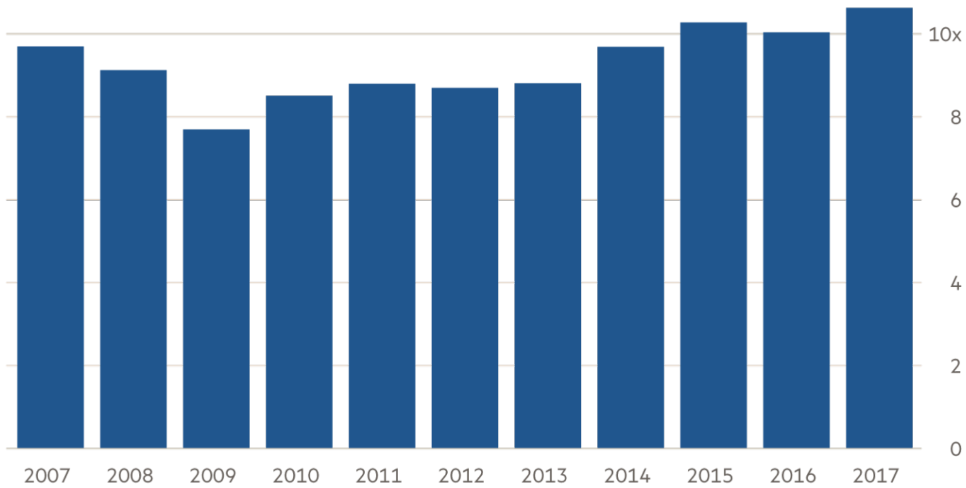
This is very close to the six-times threshold set by regulators in the US, who warned that anything over that amount "raises concerns" that deals are taking on too much risk and could lead to companies unable to repay or reduce its debt. The Nets A/S deal is expected to have net debt of more than seven times its trailing earnings before interest, tax, depreciation and amortisation.

Private equity firms are also operating in a more hostile political environment, especially in Europe where critics have attacked the turbulence that can accompany buyout restructuring.

In Britain, private equity firms have invested in water and other privatised utilities and have been accused of exploiting the regulatory system by using heavy borrowing to finance dividend payments. In Germany, the industry has been characterised by politicians as a "swarm of locusts" stripping assets from healthy companies.

Pricey assets: multiples paid for LBOs in the US

Average ebitda purchase price multiple for US leveraged buyouts




Source: LCD, S&P Global Market Intelligence
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The sea of money also makes it more likely that buyout groups will make sloppy investment decisions, warns Bill Ford, chief executive of General Atlantic, a private equity firm with $21bn of assets under management.

He says the lack of discipline is "starting to happen. At the end of the cycle [buyout groups] justify it by saying, 'It's a good company I'm paying a lot but I can get back into the fundraising market while it is strong.'" He adds: "That fundraising dynamic influences behaviour. We are seeing it right now."

Some private equity managers insist they are happy to wait for the right opportunity to invest, despite the wall of cash mounting. David Rubenstein, co-founder and co-executive chairman of the Carlyle Group, insists firms like his can still "have an edge" when asset valuations are high. "For the right deals, our industry expertise and global network give us that edge," he says. "If not, we shouldn't and wouldn't do the deal."

The firm just saw a massive writedown in its investment in the Philadelphia Energy Solutions refinery after it filed for Chapter 11 protection on Sunday, listing debts of more than $600m and undone by regulatory changes.

**The benign outlook for** the industry is that even with good deals harder to come by, private equity will still be able to produce better returns than most other asset classes.

"Returns might not be as good as in the past. But they are not an abstract fact," says Johannes Huth, head of KKR in Europe. "The returns that private equity produces [relative to] the returns you get in the stock markets or in the credit markets will continue to stay extremely attractive."

The bearish case is that with yet more money flowing into the industry, this will ultimately mean a slump in returns as investors pay high prices for deals. Already heavyweights in the industry such as Carlyle's Mr Rubenstein have warned this is likely to be the case.

For some observers, that scenario sets up an even riskier outlook, with intense competition for deals leading to a series of poor investments in companies that struggle under their new, heavy debt burdens. At some point that could tip over into more buyout firms generating losses, or even collapsing.

"A cataclysm is bound to happen," says Prof Phalippou. "The combination of overpricing and high leverage cannot lead to anything other than a lot of defaults, which in turn affect many people from employees, to customers, to the pensioners whose savings went into these overly generous debt packages."

## Terra Firma: Guy Hands and the time the music stopped at EMI

Perhaps the most potent symbol of the sector's effervescence is the revival of Terra Firma, the fund founded by Guy Hands which is now seeking to raise $3.4bn from investors. Once considered a rock star in the industry, Mr Hands is making a return to the market following the break-up of entertainment group EMI — a deal that nearly destroyed the firm.

The takeover of music label EMI in 2007 still stands out as one of the most catastrophic leveraged buyouts in European history, the epitome of an era of cheap, easy money ending with disastrous results. When he unveiled the £4.2bn deal, Mr Hands said he was acquiring "the worst company in the worst performing industry" and heroically promised to save the struggling music label, mostly from itself. Terra Firma invested £100m of its own money alongside £1.6bn from its investors and pumped it up with a vast £2.5bn loan from Citigroup.

EMI was at the heart of the music business, with artists of universal appeal — from The Beatles and Robbie Williams to Katy Perry — on its books. But it was already struggling with disruption in the industry brought by the advent of digital downloads. Terra Firma's ham-fisted management soon led to accusations from artists that Mr Hands took a "bean-counting" approach. Top performers, including Sir Paul McCartney, cut ties.

And then came the financial crisis. Hamstrung by a freeze in credit markets, Terra Firma found it impossible to extend its borrowing. The company's collapse in 2011 saw 2,000 jobs lost and all but ended Mr Hands' glittering financial career.

In 2009, out of the 315 businesses sold by private equity firms across Europe, 120 of them went bust, according to the Centre for Management Buyout Research at Imperial College Business School. EMI's demise was not an isolated case of animal spirits running out of control.