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# 'LBO bubble, what bubble?'

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**Abstract** The media suggests there is an LBO bubble: too much money is chasing too few deals; increased leverage has increased risk too much and there is an unsustainable private equity bubble forming. We classify a 'bubble' as an increase in prices of certain goods, a disconnect of prices from any fundamental valuations and a large increase in market participants with many newcomers and unusually high liquidity. Careful examination of the data, however, suggests that there is no LBO bubble forming, but that the unusual LBO activity is driven by an overheated debt market that, in the wake of the collapse of the US subprime market, has seen a correction over the summer. We expect the LBO market to slow and returns net to LPs to migrate to historic long-term averages of about 20 per cent IRR and 1.5× multiple but continuing to outperform the public markets.

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## Impact of large amounts raised

In recent years commitments to private equity have soared with 2006 seeing a record fund raise of about USD 300bn in the EU and US. This has been the largest fund raise per vintage year for private equity ever, and surpassed the USD 250bn raised in 2005. Much of this money has been committed to the LBO space, in particular to a handful of well-known companies that have been able to raise over USD 140bn alone in 2005 and 2006. An examination of the number of funds raised shows that their number has remained stable while commitments to some of these funds have increased substantially. In addition, these commitments have been mainly made to funds managed by established firms rather than inexperienced market players as was seen during the venture capital (VC) bubble. Furthermore,

this money mostly stems from 15 quarters of extremely strong distributions that are being recommitted rather than coming from new market participants.

Nevertheless, one would expect in these circumstances to see that too much money is flooding the market, with the unhealthy effect of driving up prices severely or funds not being invested. The capital overhang in the PE market of 20 per cent undrawn commitments, however, is the lowest since 1990. This can be compared to the peak just prior to the venture bubble in 1998 and 1999 of 50 per cent. This points in the direction that the increased amounts of money for private equity are in sync with the amounts LBO funds are able to invest.

Unlike in the venture space, which has a limited amount of investment opportunities, with the increased funds raised, buyouts claim just a higher percentage of the global M&A market that amounts to about USD 6 tn of transaction activity per annum in 2006. To put this into perspective, up to the year 2002 annual LBO transactions were about 5 per cent when

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compared to the overall global M&A activity. In 2006 and 2007, LBO activity reached about 16.1 and 15.4 per cent, respectively, of the global M&A market from a transaction value point of view. The ratio in terms of number of transactions comes in slightly below that at 7.8 per cent in 2006. The importance of financial sponsor-driven revenues in the major investment banks underscores this trend.

## Valuation trends

Another feature that distinguishes the current LBO situation from what we saw in the late 1990s prior to the burst of the venture bubble is the increase of transaction size. While the investment in newly founded companies has a much narrower bandwidth in terms of transaction size, LBO investments have become much larger over the last five years simply by targeting larger companies. In the year 2000, the average LBO transaction size stood at USD 276m, while it has reached an average of USD 792m per transaction in 2006. This way the LBO industry was able to absorb much of the money raised by expanding into larger companies rather than spending more money on the same type of companies at higher valuations.

An examination of the acquisition multiples for LBO companies supports this argument, as prices have become higher but remain within the historic norm. For example, the average EBITDA multiple ran at 5.5× in 1994 for LBOs under 250 million with a peak of about 7× in 1998 and again in 2006 at 7.23×. The multiples for larger transactions are slightly higher but show the same pattern. The situation of premiums paid for large public to private transaction is even better, where the average premium of announced transaction value to last available public valuation dropped from 29.59 per cent in 2000 to 17.99 per cent in 2006. This again does not point to a disconnection of prices and assets.

A further argument supporting the view that there is not an LBO bubble forming is a look at the overall company valuations. Unlike the situation in 2000 where valuations had become excessive before dropping sharply until 2002, valuations have remained stable throughout 2002–2007.

## Effect of financial leverage

Lastly, to fully understand the picture financial leverage needs to be assessed. Equity contributions to LBO investments did decrease over the last 3–4 years and are currently at an average of 32 per cent equity contribution, down from the peak of 41 per cent in 2001, which marks an increase of leverage of about 35 per cent. Equity levels, however, are still substantially higher than in the early 1990s where the average equity contribution in LBO deals was as low as 20.7 per cent. While 32 per cent seems low the virtual absence of financial covenants makes this a relative figure. Several of the very large deals with reportedly high leverage levels use notes with features such as ‘PIK toggles’ that allow the borrower company to defer any interest payment for up to eight years with only a slight increase of cost, a sufficient time-span to sit out an economic cycle under most circumstances or ‘mulligans’ that allow the borrower to take advantage of grace periods in respect of debt amortisation. Some debt tranches are also structured with little or no scheduled amortisation, requiring a single ‘bullet’ or ‘balloon’ repayment, usually at a refinancing point several years after the first drawdown.

## Leveraged loan market developments

The leverage loan market began to sour at the end of June driven by hefty losses in the US subprime market, the impact of which spread quickly. Banks put reserves aside to cover losses and several hedge funds are also reported to have incurred significant losses. On 9 August the ECB started to intervene with an EUR 95bn standby liquidity facility in an attempt to head off a potential liquidity crunch in the EU interbank lending system. Subsequently other central banks, including the Federal Reserve, have followed suit to avoid what is seen as a technical liquidity crunch in the banking market given the good overall economic climate.

During the past four months lending spreads have risen sharply. While this marks a notable increase, spreads remain well below the levels of 2001–2003. At the same time new issuance

volumes have dropped significantly. Large underwriters are encountering difficulties in clearing the pipeline of hung debt of USD 237bn in the forward calendar for the rest of 2007, which considerably impairs their ability to underwrite new large LBO transactions. The secondary loan market and high yield markets have also been affected in similar ways. Again, this reduces liquidity that otherwise would be available to private equity LBO transactions.

After a virtual shut down of the debt markets throughout the summer, the pipeline is slowly starting to clear. Nevertheless, the expected changes are coming through. While there are large transactions being closed, there has not been a mega deal since July generally. Debt covenants and terms on those deals that do close have been tightened. Furthermore, leverage multiples are coming down. This in effect will shift the focus for LBOs away from mere financial engineering to revenue generation, operational improvement and expansion of EBITDA multiple. The following example demonstrates this effect.

A sample LBO with a transaction value of USD 200m and a debt:equity ratio of 1 and able to reduce its debt to USD 60m over a period of three years with an increase of the profit margin of USD 50m over the same period, and a multiple arbitrage contribution of a further USD 60m, would generate a return of 2.5× and an IRR of 36 per cent. With a reduction of leverage to a starting amount of USD 80m and a likely reduction of the multiple arbitrage contribution, all else being equal, the same deal would generate a 1.75× multiple and an IRR of 21 per cent. These figures are much more in line with the historic average performance of private equity. Calculated differently with the above reduction in debt the company would have to increase its profit margin by a further USD 40m to achieve the same multiple. An anticipated reduction in the purchase price would help to compensate the effect of reduced leverage available to LBOs. In how far, however, the decline in purchase price is able to compensate for the reduction in leverage is hard to quantify at this stage.

A further worry is that the disappearance of the mega deals leads to a large backlog of funds

ready to be invested, which will keep prices high and contribute to the erosion of returns. Many fear that under the changed situation the mega funds will not be able to generate adequate returns. While we see a potential issue there, we believe this is unlikely to happen for several reasons. Most managers who have raised mega funds have global organisations and are able and prepared to invest their funds globally, being able to invest where they find attractive entry prices. Furthermore it is not necessary to do mega deals in order to invest a mega fund. Recently, the fund-raising cycles have shortened considerably with the managers' average time back to market decreasing to as low as two years. By going back to fund-raising cycles that are closer to the historic norm of 3–4 years, even mega funds can be invested without reliance on mega deals, as illustrated by the following example: A USD 20bn fund can be invested in 15–20 deals of about USD 4–6bn in transaction size each. This would amount to 4–5 deals per year over 3–4 years requiring leverage of about USD 25bn per year. We believe this to be realistic numbers. Deal flow in this segment should not be a problem. Companies in this size bracket in the S&P 1500 (US) and the S&P 500 (EU) alone have a market cap of well over USD 13tn. This does not include private companies in the US and EU in this size bracket or any company in Asia or CEE. We thus believe that investment opportunities are ample. It is thus unlikely that mega funds will risk returns by driving up prices now, but will rather revert back to a reduced pace of investing focusing on large rather than mega deals with less syndication to avoid complicating transactions through the excessive amounts of debt required at any given time.

Furthermore mid-cap investments are much less affected and VC markets are not affected at all. In general, we also expect values of deals done pre-correction to be safe as most of the leverage is covenant light and the economic climate continues to be strong, protecting existing values. Highly leveraged transactions or imprudently structured financings may however suffer.

## Conclusion

In summary, we argue that there is no LBO bubble. Prices are high, but not excessive. LBO firms are buying real companies, with real products and real cash flows. Most of the money has been committed by existing investors, re-investing the exceptional distributions of the last 3 and a half years, and has been placed with experienced top tier players.

Nevertheless, we expect the LBO activity to slow and returns to soften, but do not expect anything like the value destruction that has been the characteristic of the bursting of the VC bubble.

So what does it mean for pension funds? We believe three critical topics need to be considered: diversification, selection and investment horizon. The above-described situation mainly impacts the large end of the market in the US and in Europe. The impact on the mid-cap market is already much less, while venture is not affected at all and distressed sees its opportunities rising. With an adequate diversification across regions, vintage years and investment styles the turmoil in the debt markets will have limited impact on the long-term performance of a portfolio. To this end, pension funds should seek to build well-diversified portfolios and should work towards a thorough understanding of what diversification is appropriate and necessary for their needs.

The next critical element is selection. While it is critical not to try to time the market, we firmly believe that selection is a powerful means to generate returns. An understanding of current trends and events such as the debt market turmoil should be used to assess, which managers are best equipped to weather the changes and generate good returns in the future. Thus, pension funds should review their investment processes and

make sure that their market analysis supports their investment decision rather than their allocation decision.

The last argument is the investment horizon. The current changes in the market will undoubtedly have a negative impact on returns in the near future, which we expect to correct downwards to more historic levels. In the long run however, private equity has consistently generated returns that are above those of the public markets. Pension funds are long-term investors. They typically have good visibility on their cash requirements and can make relatively precise assessments. There is no reason why they should not take advantage of their long-term investment horizon and capture the illiquidity premium that private equity provides. To put this further into perspective, it is appropriate to look at private equity from a relative return perspective and not only from an absolute return perspective. Our research has shown that private equity has outperformed the public markets by an average of 2–4 per cent over the past 20 years even with randomly picked opportunities. With professional selection of investment opportunities picking the top half of performers, this out-performance is brought to over 6–7 per cent. While this sounds small, this increased performance compounds to an additional gain of about 2× to the expected public return over ten years.

In other words, we expect private equity to generate a cash-on-cash return, double that of the public markets over a ten-year time-frame. We believe that, for those investors who do have a long-term investment horizon, private equity remains an attractive value proposition and thus pension funds should continue to invest.

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