Private Equity Partners | Market Update

April 2005

In this month's commentary we respond to recent inquiries about mega-LBO funds.

Proliferation of Mega-LBO Funds

In 2002, Blackstone made headlines by closing their fourth fund at $6.5 billion, making it at the time the largest buyout fund ever raised. Blackstone is again making headlines with plans for a $10B fund, but other LBO firms also are vying for king-of-the-hill status. Carlyle recently closed an $8B U.S. fund (and a $2B European fund), while T.H. Lee and Warburg Pincus each intend to raise $7B or more. Still other firms, like Advent, Bain, KKR, Madison Dearborn and Welsh Carson each have raised (or plan to raise) funds of $3-5B.

In general, we think there is a place for these large funds today. In the late 1980's, large LBO funds had success doing very large, innovative deals. Big returns were generated by breaking-up inefficient, publicly-held conglomerates. This strategy waned, however, as corporate boards and CEOs "got the message" that they must proactively conduct their own rationalization programs or face buyers willing to do it for them. The crash of the junk-bond market and subsequent credit tightening by banks largely signaled the end of this buyout strategy.

Today, we believe large LBO funds also will have success doing very large, innovative deals but predicated on different factors:

- It is a broader LBO market today, with opportunities expanding in the technology and healthcare industries and around the globe.
- Bigger funds can do bigger deals, which further expands the universe of buyout opportunities.
- Regulatory inefficiencies like foreign trade and energy policies provide additional, large-scale opportunities for bigger LBO funds, especially those with cross-border capabilities like Blackstone, Warburg and Advent.
- The compliance cost and potential liability imposed by Sarbanes-Oxley continues to prod public companies, large and small, to go private. On a related note, many CEOs of growing private companies (and their financial sponsors) are reluctant to go public due to SOX or market conditions and instead will seek exits through sales to new financial sponsors. This will create additional deal opportunities for mega-LBO funds at the top of the food chain.
- Large LBO funds may have an advantage over big, strategic acquirers in certain transactions, thus limiting the number of competing bidders. The short-term investment horizons of many public equity investors means that many public-company acquirers avoid transactions that would negatively impact near-term results even if long-term benefits would otherwise justify investment. LBO funds are not burdened with such myopia.
- The biggest of the big need not travel in packs to hunt elephants. Clearly, LBO firms believe there are attractive returns to be made in very large transactions, which explains the proliferation of club deals—where two or more funds join forces to acquire a company that would be too big for each fund to acquire alone due to diversification concerns or size limitations imposed by their LPs. The benefit of club deals is that they reduce the number of bidding parties, which helps reduce valuation creep. The concern about club deals is they may get decidedly less clubby if trouble arises within the acquired companies.

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