THOMSON VENTURE ECONOMICS
Buyouts

PE Pros Again Break Deal Records, As Spending Spree Continues

Ari Nathanson
Jan 9, 2006

Private equity has certainly flourished from the nascent industry it was in the 1980s. Since the asset class's seeds were planted, the buyout industry has taken root and, with the exception of a few seasonal droughts, flourished. Over the past 10 years the number of private equity firms has multiplied exponentially as the industry continues to prove its worth to investors, and those firms' activities continue to account for larger and larger portions of overall M&A activity.

Private equity deal-flow over the past three years, in particular, has been the strongest the market has ever seen. In 2003, PE pros broke all previous records as they spent more than $94 billion to close 538 deals, while 2004 saw buyout shops crush that accomplishment by putting a disclosed $136.5 billion to work to chalk up 752 buy-side transactions. But as remarkable as those two years were, they've both been dwarfed by the year just past.

In 2005, U.S.-based private equity dealmakers closed 845 successful buy-side transactions, deploying a disclosed $197.8 billion to make it happen. Dollar-wise, the past 12 months of buyout activity represents a 44% increase over 2004's total, more than twice the amount of 2003's total, and upwards of 8x the amount spent by buyout shops in 2001, the industry's most recent low point.

"Looking at the market from the front end, you've seen a pretty significant spike upwards over the past few years, and while it might not remain as steep in [20] 06, I don't see it flattening out," says David Mussafer, a managing director at Advent International.

On a quarterly basis, 2005's deal numbers flow in the same upward curve. Last year's fourth quarter witnessed PE players completed 195 control-stake transactions for an all-time quarterly high of $59 billion. The previous quarterly record was Q3 2005, which saw $57 billion in PE-backed LBOs closed. The first and second quarters of 2005 saw dealmakers put $39.8 billion and $41.7 billion to work, respectively.

"[2005] was a very good year, on a comparative basis, to other years because the stock market-other than being flat-did not perform, which gave alternatives an opportunity to show their performance in a way that really spoke to investors," says Donald Marron, chairman, CEO and founder of Lightyear Capital.

Indeed, firms were more than happy to take advantage of 2005's exit market, often opting to sell to one another, as at least $24 billion, or 113 transactions (13% of the deals tracked), were sponsor-to-sponsor, or secondary, deals.

Sweet Spots

Perhaps learning from previous mistakes, 2005 was a year when private equity

players certainly did not put all their eggs in one basket. While the year did see continuing trends as far as industry choice-including the usual suspects: manufacturing, healthcare and telecom-PE pros made an eclectic array of acquisitions from beauty spas to paper pulp manufacturers.

Energy was one of last year's busiest sectors as buyout shops grabbed control stakes in traditional exploration, production and distribution companies instanced by Warburg Pincus' $2.47 billion acquisition of Dynegy Inc.'s midstream business and Natural Gas Partners' $528 million carve-out ONEOK Inc.'s Texas natural gas gathering and processing assets. But the industry also broke new ground as firms put money into alternative energy sources, such as Norwest Equity Partners' investments in Frontier Ethanol LLC and Horizon Ethanol LLC, and Diamond Castle Holding's acquisition of wind-energy developer Catamount Resources Corp.

2005 was also a year heavy in financial services investments as private equity firms began exploring different niches of that market, too. GPs like General Atlantic Partners, Oak Hill Capital Partners, Roark Capital Group and Lightyear Capital all participated in the space. "A number of specialized areas got more exposure, such as student loans and crop insurance," Lightyear's Marron says. "Overall, private equity is seeking to widen its exposure to different aspects of the industry, and there is more interest in financial services now than there was at the beginning of the year."

And interestingly enough, the automotive industry-which attracted much stigma last year after the General Motors and Ford high yield downgrades and a stream of bankruptcies-saw a good deal of play from generalist firms like Kohlberg Kravis Roberts & Co., Platinum Equity and Bain Capital, as well as from turnaround players, such as W.L. Ross & Co. and KPS Special Situations Funds.

Other popular industries in 2005 include restaurants and other food-related assets, retail (particularly apparel), and software.

Fears For Tiers

In a perfect world, when one sees high purchase price multiples placed on companies, they should be safe in assuming that it is a quality asset. But with some predicting a downturn in the market, and thousands of companies having changed hands over the past three years at what some euphemistically refer to as "healthy multiples," the question can be raised: Is there still an ample supply of top-tier businesses to invest in, or are investors having to lower their expectations in order to put their capital to work?

Jack Helms, a managing director at Goldsmith Agio Helms, says the quality of companies hitting the market these days has not shown a decline. "We have not seen anything like what happened in 1999, when there was a marked change in company quality preceding the downturn in the market."

Helms went on to say that the combination of a strong economy, a hot seller's market and the increasing efficiency of the PE asset class is helping keep the pipeline filled with top-tier assets. "Firms are recycling investments in shorter time periods," he says. "People are no longer shy about flipping a company after only two to three years, and companies are better able to retain their quality because of that."

But while market efficiency and economic prosperity may be helping with quality on one hand, some hold that relying on these factors to determine value would be the equivalent of walking through life wearing a pair of rose-colored glasses.

"One of the big trends is that a lot of what people are seeing comes through auctions, and that alone is forcing companies to ensure that they have their stories and their financials in line," says Daniel Farrar, a general partner at Morgenthaler Partners."So only through your own diligence can you see what's

under the hood, because the auction processes really dress up these companies."

Gone Clubbin'

One prominent characteristic of 2005 is the chummy nature that firms took on with one another to get deals done. Of the 845 deals completed last year, 125 of them were club deals, where teams of two or more private equity firms worked with one another to share the costs and responsibilities of the transaction. Statistically speaking, that means that private equity firms chose to team up nearly 15% of the time. More telling is the fact that $102 billion-more than half of 2005's disclosed U.S.-backed deal-flow total-came from these transactions.

That such a large percentage of activity came from club deals a is pretty clear sign these transactions have gained acceptance among the broader investor population, despite the fact that they have come under the occasional fire of limited partners and skeptical PE observers.

"If the club brings diverse and specific skills and capabilities to an investment, then that's a good thing," says one deal pro whose firm participated in three consortium deals last year. "If all they're doing is glomming on to one another for lack of opportunities, then that's a bad thing, especially when taken in the context of LPs, which go to great pains to diversify their money. So we want to be very careful that every deal we invest in, we have specific ideas and skills related to that investment that bring the company to a higher level of performance or a better position in the market."

The common pro-club argument is that it allows firms to break into a market that is otherwise too large to prudently play in alone. Thus, not surprisingly, the largest three private equity deals to close in 2005 were all club deals.

The largest deal of the year, the $15 billion buyout of Hertz Corp. from Ford Motor Co. by Clayton Dubilier & Rice, Carlyle Group and Merrill Lynch Global Private Equity, closed just last month. That deal was announced on the heels of the $11.3 billion buyout of SunGard Data Systems by Silver Lake Partners, Blackstone Group, Texas Pacific Group, Thomas H. Lee Partners, KKR, Providence Equity Partners and Texas Pacific Group, which closed shortly after the $8.8 billion taking-private of Toys "R" Us by KKR, Bain Capital and Vornado Realty Trust, both of which took place in the third quarter.

And as the deal sizes continue to grow, some buyout pros see no end to what is possible. "I can imagine somebody buying General Motors," says Stephen Hoffmeister, a principal at Advent International. "It's a troubled situation, and I don't think there is a limit to what the large-market guys are capable to doing. We've seen the precedent set where seven of these firms can work together, and each has the capability of committing up to $1 billion of equity."

Email Ari.Nathanson@thomson.com

Back to Top News