The Bust of the Private Equity and LBO Bubble...or the End of Schmalpha...

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For the last few years owners of private equity firms had been the new "Masters of the Universe". At the 2007 World Economic Forum in Davos last year it was almost impossible to get into the panel on private equity as they were fully booked from the very first day. And I remember the head of one of the leading private equity firms cockily arguing in a session that all was fine in that industry and any attempt to regulate it or tax it otherwise was inappropriate interference.

But what a difference a year makes! Yesterday's Masters of the Universe are now in the dust as the private equity and LBO bubble has now gone bust. By now dozens of LBOs announced in 2007 have been either restructured, postponed or cancelled altogether; also **seven actual medium sized LBOs have gone into bankruptcy** this year alone and many more of the bigger ones may also go bust.

Let us next flesh out in more detail this bust of the private equity and LBO bubble…

The current private equity bust is no surprise as the previous LBO boom was all driven by the easiest credit and liquidity conditions ever. Until last year there was a slosh of liquidity and credit with spreads on junk bonds so low (260bps last June) and rates on leveraged loans financing LBOs also so low that any private equity firm could take private any marginally profitable firm, load it with cheap debt and levered it to the max and still make a very good return on the investment. Even so, as recent **academic studies have suggested**, a lot of the return that private equity firms generated was "**schmalpha**" rather than "alpha", i.e. driven by the **high commissions and fees and guaranteed payments that owners of such private equity firms were obtaining from such deals rather than true value generation**.

This LBO craze ran amok until mid 2007. Indeed, in the last two years a typical LBO deal had a debt to EBITDA ratios of seven or eight when the historical average for LBOs was closer to three. And not only these deals where excessively leveraged: the terms for them did not make any sense for investors in leveraged loans as they were with debt at very low spreads, loaded with covenant-lite features and with PIK (payment-in-kind) toggles that allowed even otherwise distressed firms to postpone the time of a bankruptcy.

But now that the credit markets have gone into a severe crunch the LBO craze is going bust. Junk bond yield spread have gone from 260bps to over 700bps; **$200 billions of leveraged loans** are stuck on the balance sheet of financial institutions and **are trading on 80 cents on the dollar** (leaving them with massive losses); the utter nonsense of covenant-lite and PIKs is history; most announced LBO deals are postponed or scrapped; and lawyers are recommending to private equity firms to walk away from deals that don't make sense any more.

Much worse: there is now evidence that an increasing number of previous LBO deals have gone into bankruptcy. Seven private-equity owned firms have gone into Chapter 11 bankruptcy in the last month alone. As reported by **WSJ's Deal Journal** these seven LBOs gone bust are:

- ***Sirva Inc.**, a moving company bought by Clayton Dubilier & Rice Inc. in 1999 by combining two companies CD&R owned, in a deal worth $450 million;*
- ***Wickes Furniture**, furniture retailer bought by Sun Capital Partners and furniture vendor Rooms to Go in 2002 for an undisclosed price. Sun Capital bought out the interest of Rooms to Go in 2004 for an unknown sum;*
- ***Blue Water Automotive Systems**, car parts provider bought by KPS Capital in 2005 for an undisclosed price;*
- ***PRC Inc.**, a call-center operator bought by Diamond Castle Holdings in 2006 for $286.5 million;*
- ***Buffets Holdings**, a restaurant operator bought by CI Capital in 2000, for $643 million;*
- ***Heartland Industries**, lubricant distributor bought by Quad-C Management in 2002 for an undisclosed price and a total equity investment of $39 million;*
- ***Propex Inc.**, a maker of carpet backing bought by Sterling Group, Laminar Direct Capital and Genstar Capital in 2004 for $340 million.*

And this is only the beginning of a large wave of LBO bankruptcies that will surge over 2008. Some of the bigger LBO deals of the last few years look shaky and could go bust: these include **GMAC that is now burdened with massive sub-prime and auto loans losses**; and Chrysler that flopped when bought by Daimler and is now doing even worse after being taken private by Cerberus. No wonder: Cerberus is run by one of the most mediocre Treasury Secretaries in US history (John Snow) who gave the job of running Chrysler to Bob Nardelli, of Home Depot infamy. And the best that the new owners of GMAC could come up with is that "*The good news is that we bought GMAC cheaply enough so that even with all the bad news in the mortgage market and credit markets, we still are in reasonable shape with our overall investment*". The same could be said of the Chrysler dud.

Add to this ugly picture the recent news that KKR Financial, Kohlberg Kravis Roberts & Co.'s publicly traded fixed-income fund, is now in serious financial trouble and both its mortgage and leveraged loans investments in private buyout deals are going sour. As reported by Bloomberg:

__KKR Financial Holdings LLC__, Kohlberg Kravis Roberts & Co.'s publicly traded fixed-income fund, delayed repaying debt issued by two units after failing to find investors willing to refinance the commercial paper.

The units' lenders agreed to the extension, the second in six months, as KKR Financial continues discussions on restructuring the mortgage-backed notes…

The company also has $6.4 billion invested in high-risk, high-yield loans and an additional $931.2 million in other corporate debt. The finance unit invested in the debt of KKR buyouts including loans of Dallas-based Energy Future Holdings Corp., formerly TXU Corp., and Colorado-based credit card processor First Data Corp.

KKR Financial bought the debt backing other firms' acquisitions including Tribune Co., purchased by __Sam Zell__ in December, and Apollo Management LP's Realogy Corp., according to a presentation Netjes gave at a Credit Suisse Financial Services event Feb. 6 in Naples, Florida.

Leveraged loan prices have fallen from par last June to 88.6 cents on the dollar as banks struggle to sell debt promised to buyout firms and fears of rising defaults, according to S&P.

Speak of "connected lending", the incestuous inter-firm lending deals that led to financial trouble for the Japanese keiretzus and the Korean chaebols. Here we have the public finance arm of a private equity firm creating conduits to buy the leveraged loans issued by another arm of the same firm in its private equity deals and then getting in financial trouble. So much for proper and sound corporate governance and transparency! No wonder that the East Asian that were lectured by the U.S. during their 1998 financial crisis about the flaws of their corporate governance and about the dangers of "connected lending" and "directed lending" are now seeing that the same rot had taken hold of the most advanced and sophisticated financial markets in the world. So no surprise that in Asia the current crisis and predicament of the US credit and financial markets are considered as a form of poetic justice.

In conclusion, a private equity bubble and LBO bubble driven by a broader credit bubble of cheap money is now going bust. And, as in the case of other corporate defaults that are now going surging at alarming rates, the LBO bubble bust will be ugly as in recent years the business model of such private equity deals was predicated on stacking otherwise borderline profitable firms with loads of debt and little equity and hoping that credit will remain cheap. That hope has been dashed by the repricing of risk since last summer and a severe credit crunch. Covenant-lite terms and PIKs may delay by a few quarters the eventual bankruptcy of many LBO deals but this will come at the cost of a more painful and spectacular busts down the line.

So, the private equity bubble and LBO craze has gone bust and yesterday's Masters of the Universe are now in the dust. Private equity and LBOs have of course a future and some past LBO deals were sound and profitable. But the LBO bubble generated by a slosh of cheap credit is gone. From now on LBOs will make it or break it based on the soundness of the investment opportunity rather than financial chicanery and reckless leverage. The private equity industry may thrive in the future and the best operators in this business will be able to survive the current credit crunch and financial turmoil and do well. But the era of easy money and easy credit and buy-outs that made sense only with cheap credit is gone.

PS: According to **Bill Janeway of Warburg Pincus** "Alpha is the money you make when you perform better than the market. Schmalpha is the money you make when you perform better than your clients...". I.e. it is the return you make when some naive investors are willing to let you manage their money for high fees and you get them lousy returns.