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Why the private equity bubble is bursting

Loans will go bad, deals will be canceled, fortunes will be lost. The sudden end of cheap financing is wreaking havoc on the buyout market, says Fortune's Shawn Tully.

By Shawn Tully, Fortune editor-at-large

(Fortune Magazine) — *Michael Psaros is ready to pounce. Perched in his office atop Manhattan's MetLife Building, with its sweeping views of Central Park and photos of the sun-splashed Greek isle of Chios, home of his forebears, the 40-year-old is convinced that the spreading wreckage in the buyout world will serve up the best deals of his life.*

Psaros is a managing partner of KPS Capital Partners, a firm that specializes in buying and rebuilding troubled industrial companies. A contrarian with a keen eye for market trends, he sold eight of his 11 companies as he watched the private equity frenzy mount over the past 14 months. "The prices were incredible," marvels Psaros. "The market is completely out of touch with economic reality." Now he's poised to move back in. KPS just raised $1.2 billion to buy companies that, Psaros reckons, LBO shops and lenders will jettison at desperate, distressed prices. "It always turns on a dime," he says. "All of a sudden you can feel the fear."

It's looking more and more as if the private equity phenomenon was a classic Wall Street bubble. It brought unprecedented riches to investment banks, minted a flashy new generation of billionaire Masters of the Universe, and bestowed

bubble is bursting

a magical aura on leveraged-buyout specialists like Carlyle and Kohlberg Kravis Roberts. And now the bubble's bursting. Loans will go bad, deals will be canceled, fortunes will be lost. We're witnessing the unwinding of the whole dynamic that propelled the stock market (not to mention Manhattan real estate prices) to record highs.

Alarm bells are ringing. Since mid-July, worries about risky debt have helped drive the S&P 500 down by 6%, wiping out about two-thirds of this year's gains. At least one big hedge fund, Sowood Capital Management, run by a former member of the team that steered Harvard's endowment, has gone bust. And banks have been unable to syndicate loans financing several high-profile buyouts, including those of Chrysler, First Data and ServiceMaster.

The bursting of the bubble will inflict broad damage. The cascade of private equity deals will slow to a trickle - and the firms that vastly overpaid for their targets at the peak of the frenzy in the past two years - when, by the way, most of the deals were done - will deliver extremely low returns to the pension funds, university endowments, and wealthy families that invested in them in recent years.

Second, investors in high-yield debt will suffer. The worst victims will be hedge funds that kept the good times rolling by buying the riskiest junk bonds and bank debt, often on margin - the strategy that sank Sowood, which saw 50% of its assets evaporate in the meltdown.

The suffering won't be confined to the professionals or the wealthy. Ordinary investors who have money in corporate or high-yield bond mutual funds will feel the pain. And so will stock market investors. Until recently many stocks benefited from a takeover premium - it seemed that virtually any company in any sector, from gaming to hotels to retail to software, could be bought at a royal price by a leveraged-buyout specialist like KKR or Blackstone. Suddenly the buzz, and the takeover premiums, have vanished. Especially hard hit are the players heavily touted as LBO targets. In just three weeks Corinthian Colleges has dropped 16%, Martha Stewart is down 25%, and Radio-Shack has plunged 30%.

The seeds of its own destruction

The private equity saga follows the timeless template of financial frenzies. Its roots go back to the bursting of the tech and telecom bubble in 2000, which saw stock prices decline 40% and threatened to pull the economy into recession. In response, the Federal Reserve pushed interest rates to rock-bottom lows to keep the economy humming. And hum it did. While stocks stagnated, the economy and corporate profits kept chugging along.

The combination of low interest rates, depressed stock prices, and rising corporate profits created ideal conditions for private equity firms to flourish. Using dollops of cash and bushels of debt, they were able to snap up solid companies on the cheap - in 2002 buyout prices averaged just four times cash flow (defined as earnings before interest, taxes, depreciation, and amortization, or Ebitda). In a typical deal a private equity shop would borrow about 70% of the purchase price (those loans go on the acquired company's balance sheet, often doubling or tripling its debt load).

With that kind of leverage, even modest improvements in the company's profits generated huge returns for the private equity firms and their investors. In some cases, they paid themselves dividends that allowed them to recoup their entire investment within a year. And to top it off, they raked in huge fees from the companies for arranging the deals and the financing, as well as for managing the business. (The deals also got a boost from Uncle Sam. The interest on all that debt is tax-deductible, so the companies saw their tax bills drop drastically.) The math made the buyouts bulletproof. "The market was so good that dead people could have made money on LBO deals," says Chris Whalen, a managing director at Institutional Risk Analytics.

Like every mania, this one carried the seeds of its own destruction. The lure of easy riches drew new players, and the pace of dealmaking picked up. In 2005 there was a string of splendid deals at reasonable prices. For example, TPG (formerly Texas Pacific Group) and Warburg Pincus scooped up Neiman Marcus for $5.1 billion, and a group led by Clayton Dubilier & Rice, Carlyle, and Merrill Lynch paid $5.6 billion for Hertz (these prices don't include the existing debt of the targets).

As the good times rolled, the buyout binge took on a life of its own. The real craziness started in 2006. Dazzled by rich returns, investors threw more and more money at private equity firms. Flush with cash, the PE shops started pushing

bubble is bursting

prices to unsustainable heights. The firms were not only making initial offers at big premiums over the target's current market value, but getting drawn into bidding wars that drove the prices and the premiums still higher. Last year Blackstone bid $16.4 billion for Free-scale Semiconductor - nearly a 30% premium to its market value, which had already been boosted by takeover talk. After KKR came into the picture, Blackstone had to sweeten its offer to $17.6 billion to prevail.

Shareholders of target companies soon figured out that they didn't have to accept the first bid that came along, no matter how rich it was. Last year Clear Channel shareholders rejected a 33% premium from Bain Capital and Thomas H. Lee for the radio group. The firms clinched the deal only after upping their offer by $800 million, to $19.3 billion. By early this year the average buyout price was clocking in at 15 times cash flow - nearly a fourfold increase from the 2002 level and matching the level reached just before the LBO market blew up in the late 1980s.

In another sure sign of froth, the firms traded companies to each other at ever higher prices instead of selling to corporate buyers. Blackstone recently sold Extended Stay Hotels to Lightstone Group for $8 billion, $6 billion more than Blackstone bought it for in 2004. And then came an unmistakable sign of a top: Private equity firm Blackstone went public (the stock is off 35% since its June debut), and others talked of following suit. Those plans are now on hold.

Paying higher prices meant borrowing more money; as debt levels grew, interest payments absorbed a bigger portion of cash flow, eliminating the margin of safety that made the earlier deals so compelling. In the recent $12.2 billion buyout of Univision, the Spanish-language TV network, interest payments on its $10 billion debt will eat up virtually all of the company's $760 million yearly cash flow. "Univision has good growth prospects," says John Puchalla, an analyst with Moody's, "but it will need both good performance and a strong economic environment to manage the huge debt load." The big leverage on recent deals practically guarantees that default rates on buyout loans will soar from the current rate of less than 1% to at least their historical average of 5% to 6%, and perhaps a lot higher.

'Because we can finance them'

Now we come to the other half of the buyout equation: the lenders. Buyout firms borrow through banks and by issuing junk bonds (in the name of the companies they're acquiring, of course). Among the key enablers of the buyout boom were investors searching for yield. With rates on supersafe Treasuries at historical lows in the early 2000s, the usual suspects - led by hedge funds and Asian and European banks - were happy to snap up all the high-yield debt the market could offer.

And they seemed blissfully insensitive to risk - even junk bonds rated a scary C were selling briskly, accounting for more than 25% of all LBO junk-bond issues earlier this year. "Bonds are usually downgraded to that rating when they're near default," says Mike Rowan, managing director for corporate finance at Moody's. "It's unusual to see new issues at that level." In fact, the last time C debt was issued to raise money was during the telecom bubble, and we all know how that ended.

It wasn't just junk-bond investors - banks drank the Kool-Aid too. The loan covenants, or conditions the banks imposed on borrowers, became far looser. These "covenant lite" credits frequently dispensed with traditional requirements that companies keep a comfortable cushion of cash flow to cover interest payments or else pay down debt. They also often allowed companies to borrow more money to pay interest, a feature in many deals, including Univision, that resembles the negative-amortization home loans (which allow homeowners to add unpaid interest to the principal) that juiced the mortgage market.

Ready access to a seemingly bottomless source of funds encouraged buyout shops to make ever bigger and bolder bids. "I kept asking people from the firms, 'Why are you paying these prices?'" says Michael Tennenbaum, 71, of Tennenbaum Capital Partners, a $7 billion investment firm specializing in distressed debt. "They said, 'Because we can finance them.'"

That's not how markets are supposed to work. As the deals became more daunting, investors should have demanded far higher rates to finance them. But incredibly, in the past 18 months, money effectively got cheaper. From late 2005 until the July meltdown, the spread between high-yield debt and ten-year Treasury bills - in

bubble is bursting

effect, the price the market puts on risk - contracted from 3.8 percentage points to 2.6 points.

The cheap money just pumped the bellows, and the pace of dealmaking accelerated. In 2006, U.S. LBO firms notched $422 billion in announced deals, dwarfing the record $156 billion in 2005, according to Dealogic, a capital-markets research firm. That incredible pace actually accelerated again through June. The buyouts also mushroomed in size. The two biggest buyouts of all time were announced this year: Canadian phone giant BCE, at $48.5 billion, and Texas energy giant TXU, at $43.8 billion. (All the figures in this paragraph include the existing debt of the company being bought.) A few weeks ago Wall Street was buzzing about the likelihood of the $100 billion private equity deal. The party had gotten out of control.

Risk on top of risk

Then the music stopped. The trouble began with rising defaults in the subprime mortgage market. While that market is unrelated to the buyout financing, the problems there served as a wake-up call. Suddenly debt investors began - for the first time in years - facing up to the risks they were taking. In mid-July the spreads on high-yield debt exploded, hammering the prices of junk bonds and loans. "This is one of the sharpest corrections I've ever seen," says Tennenbaum, who saw the bust coming and is paying 85 cents on the dollar or less for loans that sold at full value three weeks ago.

Today the entire money-raising machinery that powered the boom has seized up as lenders awaken to the danger in these deals and insist on being paid for it. Investors are torturing Wall Street underwriters by demanding far bigger yields on junk bonds and loans than they were willing to accept as recently as June. The market for C debt - the great enabler - has evaporated entirely.

That doesn't mean that the highly touted deals that have already been announced won't be completed. It's likely that all of them, including First Data and TXU, will obtain financing. That's because the banks that underwrote their debt are contractually obligated to fund the deals at fixed interest rates. But the banks will take a bath on those transactions.

For the private equity shops, higher rates reduce the potential value of the companies they hold, since a new buyer will pay more in interest to carry the debt. "If spreads on high-yield debt stay this wide, it's extremely negative for the profitability of private equity firms," says legendary investor Carl Icahn.

The biggest losers, though, are likely to be the swashbuckling hedge funds that gorged on high-yield debt and did it in the most reckless way possible. To amp up their returns, they borrowed heavily to buy the bonds of already highly leveraged companies. That's piling risk on top of risk in a rickety structure that a slight bump can topple. Wall Street firms promoted the practice. Not only did they sell high-yield bonds to the hedge funds, they also lent them money through their prime brokerage arms to buy the bonds on margin. It wasn't uncommon for the funds to borrow 80% of the price of the loans. With that kind of leverage, for example, they could earn 18% or more owning bonds with a nominal interest rate of 10% or so.

The same leverage that magnified their returns will multiply their losses, with potentially dire effects. Here's what the worst-case scenario might look like: As the hedge funds get margin calls from Wall Street, they're forced to dump their holdings of loans and bonds to raise cash. The glut of distressed debt for sale crashes prices and pushes yields to towering levels. Then everyone holding high-yield debt, from Asian banks to small investors with money in junk-bond mutual funds, will take a horrendous pounding.

What we're seeing here is simply sanity returning to the market. And as always in the aftermath of a bubble, sanity returns the hard way. ◆