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BUYOUT BONANZA

Emerging trends in a booming sector.

Fuelled by extremely strong returns in recent years, the buyout market has seen a record amount of fundraising in 2005 and 2006. Buyout funds raised over \$175 billion globally in 2006, up from only \$50 billion in 2003 and much higher than the previous peak of about \$90 billion in 2000.¹ Amidst this fundraising bonanza, several prominent themes have emerged.

First, the largest funds have dominated the current fundraising cycle. Although large funds have long accounted for a disproportionate amount of capital raised, the concentration has increased significantly in recent years. For example, from 1995 to 2004, the top decile of buyout funds by fund size accounted for an average of 50% of total buyout capital raised annually. This proportion rose to approximately 60% in 2005 and 2006 when the first buyout funds in excess of \$10 billion were raised, led by Blackstone Capital Partners' \$20 billion fund. The largest firms are now truly global in scope, with offices and investment activities across the United States, Europe and Asia.

Second, club deals, in which several buyout firms team together to purchase an asset, have become increasingly prevalent in recent years. Such syndicates enable buyout firms to spread investment risk, marshal more capital to purchase larger companies and draw on a broader pool of expertise to complete complex transactions and effect operational improvements post-acquisition. However, there are several potential pitfalls associated with club deals. Multiple owners may clash over strategic and operational initiatives, thereby impairing their ability to act quickly and decisively, especially if a portfolio company begins to struggle. Perhaps most importantly, clubs deals have recently attracted increased regulatory scrutiny, including from the U.S. Department of Justice for potentially anti-competitive behaviour in their bidding activities.

Third, low interest rates and extremely accommodative credit markets have driven a steady increase in pur-

chase prices and debt levels in buyout transactions. In 2005 and 2006 both acquisition and debt multiples reached levels close to the most recent peak in 1998. In addition, high-yield default rates in the U.S. have reached historically low levels over the past two years. These extreme conditions likely cannot persist. What remains to be seen is whether the buyout market will experience a soft landing or a more severe shock, giving rise to attractive opportunities for distressed investors.

Finally, despite the stellar performance of buyout funds in recent years, there appears to be a healthy conservatism among buyout funds and their limited partner investors with respect to future return expectations. Several major U.S. pension funds have reduced their target returns from private equity by 100-300 basis points and one recent LP survey found that over 90% of respondents expect net returns from new U.S. buyout commitments to be less than 20% (although almost half still expect returns in the 16-20% range).

Although buyout funds in aggregate have produced superior returns in the past couple of years, over longer time periods average buyout returns have been much closer to those of public equity. It is the top quartile of buyout funds that have produced strong excess returns over the long term. Going forward, buyout funds must continue to find attractive opportunities for the increased amount of capital flowing into the sector in order to sustain their excess returns.

Successful buyout investors will be those that take a long-term approach to the asset class and are able to skew their portfolios towards the top quartile. The latter will likely include a focus on managers with specialized sector expertise and those able to drive fundamental operating improvements in their portfolio companies rather than relying solely on financial engineering and multiple arbitrage. ■

Footnote

1. Thomson Venture Economics.