

When will the M&A joyride end?

BY RYAN KUHN

The dealmaking rollercoaster ride continues through 2006, with private equity players at the controls of ever-larger transactions. There's little mystery in the reasons for the boom: cheap, plentiful credit and a vigorous US GDP that supports rosy demand forecasts. Also increasingly important in the US, private equity deals offer a way for owners and managers to dodge onerous public company regulations by using LBOs to go, or to stay, private.

So what's wrong with this picture? Only the knowledge that big, financially-engineered deals have a nasty habit of falling on their debt swords.

A few examples: Back in 1989, when KKR bought RJR Reynolds for \$31bn using only \$1.5bn in equity, the overleveraged company – festooned with junk bonds – lurched forward for 15 years before its remnants were sold at a loss. In absolute dollars, this deal remains the biggest LBO on record.

Before it collapsed in 1998, the balance sheet of hedge fund Long-Term Capital

Management showed equity of \$4.7bn versus debt of about \$125bn. This slim equity slice offered little cushion when asset values plunged. LTCM was so large that its demise sparked fears of a national liquidity crisis.

The last time anyone saw financials for wobbly mortgage giant FannieMae was 2003. Even then, it wasn't pretty: \$22bn in equity and \$963bn in long-term debt. Again, the risk is massive financial assets and debt supported by paper-thin equity. With FannieMae's stock price down 20 percent in the last two years amid accounting irregularities, many analysts expect more bad news to come.

In retrospect, the balance sheets of these artfully constructed behemoths look like disasters-in-waiting. What's curious is why they didn't look that way to lenders then. Are today's commercial bankers better at resisting the momentum and glamour of big number promoters, or do they still believe some deals are just too big to fail?

Recent developments give pause: creditors claim that the leverage used by Bain Capital in its 2000 purchase of KB Toys, and by Fremont Partners in its 2002 purchase of Nellson Nutraceuticals led to the targets' subsequent bankruptcies. With only \$18m in equity, Bain bought KB for \$302m, divvying itself \$121m after close. Fremont bought Nellson for \$300m, then passed itself \$55m in dividends from the proceeds of a new \$100m debt tranche. According to Dealogic, the money flowing from targets to PE firms in such 'dividend recaps' has increased from \$7bn in 2004 to more than \$38bn so far in 2006.

Big PE deals are doing more than grabbing headlines: they're driving up overall M&A deal statistics. Thomson Financial says that M&A deal volume for the 12 months ending in August grew 7.5 percent over the same period last year, less than earlier growth rates. But deal value jumped to \$1.1 trillion, up 23 percent, most of this driven by PE

group mega-deals that camouflaged slowing mid-market activity. Since then, the big deals have marched to new heights: November alone saw Blackstone buy Equity Office Properties for \$36bn, and a PE firm consortium buy HCA for \$33bn.

For our part, we've encountered for the first time PE firm buyers relying on the theoretic economies of scale that may come through future add-on acquisitions to justify what they're paying for platform companies now. And we estimate that the number of PE firm associates prowling every corner of the market for targets has increased 50 percent in the last two years. With the rapid rise in PE groups pursuing M&A, deal prices are up. According to American Venture Magazine, the average EBIDTA transaction multiple has risen from about 4x in 2003 to today's 8x-10x.

In sum, some factors that could slow the current American M&A parade over the next several years are: rising interest rates, a sluggish economy brought on by new taxes, and rising deal prices. At least one of these probably will dent activity levels, but none of them is likely to bring transactions to a quick stop. The Federal Reserve has reached an uneasy equilibrium at current rates, and is in any case unlikely to raise them rapidly. Similarly, while the new Democratic majority threatens higher taxes, we'd have a few years before the economy felt an impact. And deal prices, while rising, are apparently still generating attractive PE firm IRRs.

What *would* dead-stop the current M&A parade is a rash of spectacular LBO bankruptcies that looses upon the land a fresh hell of regulators and litigators while driving lenders back into their bunkers. Should this occur, the press and politicians will predictably tar 'greedy' PE firms. But if blame be placed, forget not the eager commercial bankers and junk bond buyers who ignored the history of too much debt. ■

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