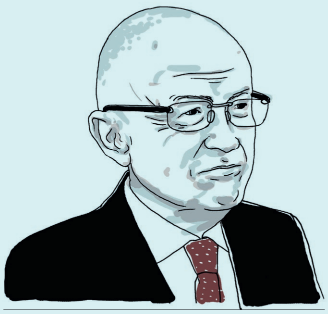
Jon Moulton's Diary

Nothing new under the Sun: how LBO firms are becoming like super large publicly owned companies



Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

I have lived in an evolving private equity world for more than 40 years and seen an immense growth in this asset class.

Far and away the largest growth has been in buyouts, with the net asset value of the buyout universe increasing more than 100 fold in the past two decades. The aggregate portfolios are well in excess of $2tn.

Much of the early growth in buyouts was buying parts of conglomerates from publicly listed companies, which were themselves owned mostly by large financial institutions and asset managers.

Early returns were really good, driven by ill-educated sellers and serious leverage (10:1 debt equity ratios were not unusual) with an unknowable benefit (or detriment!) from the managerial interventions of the LBO firms and gains from greater professionalism being applied as the LBO firms sold out their positions.

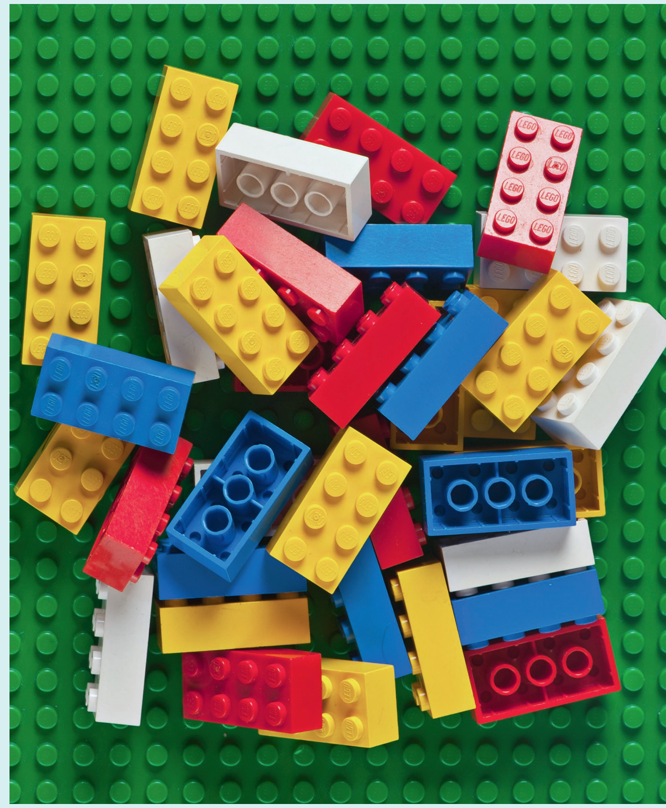
Everything went as you might estimate. Transaction values and LBO volumes exploded. The LBO funds were funded by the same institutions and asset managers that had owned the original over-diversified conglomerates.

Rent takers

The advent of the LBO funds did not really affect the basic position that there were investors and businesses. The rent-taking intervention of the LBO funds, and the tax and leverage advantages they had, made LBO firms wealthy. Lots of companies had previously been owned by the institutions through the stock markets – those markets lost share to the private market.

LBO firms are themselves an asset manager so a retail investor would often invest via an asset manager which would itself invest in another asset manager (the LBO firm). Difficult to rationalise transactions became common – secondary and even tertiary LBOs moved ownership around private equity firms without a compelling logic as to why this benefitted the class of ultimate investors.

'Big LBO funds are converging on becoming diverse financial institutions'



PE firms are growing bigger and more complex – a bit like the large conglomerates they took chunks out of in the early LBO days

LBO firms grew and grew. They have often diversified into credit funds, property funds and numerous variants thereof. Indeed, it is far from rare to see these asset managers (formerly LBO houses) raising retail funds and investing them into other firm's buyouts. Big LBO funds are converging on becoming diverse financial institutions.

Investors and fees

At the same time you are seeing large investors increasingly investing directly into LBO transactions to reduce fees thus becoming LBO firms themselves.

It is confusing. Even more so when you consider that LBO firms (diversified or not) have listed on the stockmarkets. This is part of the natural tendency of all asset managers to seek to raise and retain funds under management. More funds equals more fee income.

As I have written elsewhere, finding good transactions in the large LBO world is not as easy as it was and multi-billion funds have limited targets to seek to buy. LBO firms/asset managers do not want to have to sell out and return capital to their investors. So bright brains came up with ideas of long term "patient capital" funds with 15-20 year lives. (There is no evidence that these funds will be good for companies or investor. Academic evidence is that shorter holds generally do better that long ones.)

Then came an even brighter soul with the light bulb moment of devising permanent capital funds where you never returned the assets. Actually, at a small scale these have been around longer than me – but the volume has exploded in recent times.

So now we have LBO funds/asset managers with permanent capital and portfolios of diverse companies in a listed company.

Remember those despised conglomerates?

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