Family Office
& Private
Wealth
Management

WSL Family Office &
Private Wealth Management, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087

www.wslwealth.com

Views From the Stream

April 30, 2024

Oh, Those Poor Private Equity Firms: Reminiscences of an LBO Boom/Bust, Portfolio Companies As Trading Sardines, & The Tide Goes Out

In 1987, I graduated from business school. I remember not telling my parents in late 1984, when I applied, that I only applied to two business schools, Harvard and Wharton. For my 23 year old self, it made perfect sense and exhibited clearly that the male brain does not mature until several years later. It also exhibited the type of risks I took every day at work doing commodity arbitrage where we were levered at a mere 6 to 1 on a good day. My parents would have said "You're nuts!". However, it worked out for me as I got into Wharton. And when I told them of my acceptance, they were delighted, especially having never heard about my application approach. When I graduated, I needed a job to pay back the loans that I took to pay for school. I found employment with Drexel Burnham Lambert. The firm built its name on sub-investment grade debt utilized to buy companies in Leveraged Buyout (LBO) Transactions and/or to recapitalize a company. Either way, the goal stood to extract as much value as possible over time while putting up as little equity as possible. Eventually this debt came to be known as Junk Bonds. LBO firms came to use this debt as the primary means to fund their purchases of companies. And Drexel stood one of the Go To companies to raise the debt. For the LBO firms, the more leverage the better, whether the target company could really afford it or not. The goal stood to recycle the company to another buyer or to take it public once they harvested the cost cuts and potential cash the company could throw off. Of course, this would occur at a higher price after a short period of time. There existed little to no thought to hold the companies for the long term. The goal stood to turn them over as quickly as possible.

The easiest way to understand this approach comes from a famous story from Seth Klarman's 1991 book, *Margin of Safety: Risk Averse Value Investing Strategies for the Thoughtful Investor*. In this book, he describes a trading frenzy in sardines as follows:

> *There is an old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal*

WSL Family Office &
Private Wealth Management, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087

www.wslwealth.com

and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, "You don't understand. These are not eating sardines, they are trading sardines."

Thus, LBO Firms viewed their prized acquisitions, in some sense, as the Trading Sardines in the story above. This era encompassed the founding of current well-known firms such as KKR, Blackstone, and Carlyle Group that utilized this debt to drive their initial acquisitions and profits. Of course, as in any good idea on Wall Street, the idea gets taken to an extreme. And these extremes, which ignore the underlying economic fundamentals that originally supported the idea, tend to blow up. This era culminated in the famed 1989 buyout of RJR Nabisco by KKR for $31.5 billion. There came such public revulsion and opprobrium after this buyout fight that Junk Debt and LBO Firms became viewed in a harsh, negative light. Then, when the economy entered a recession in 1990 causing the profits and cash flows of these leveraged companies to drop significantly, the pool of buyers to buy at ever higher and higher prices evaporated. Fundamentals once more mattered. By the end of the recession, Junk Debt traded at 50 Cents on the Dollar as companies could not pay the interest heaped upon them. And investment firms built upon this mountain of debt, such as Drexel Burnham Lambert, went out of business, putting many other firms that provided credit to them at risk. This financial implosion almost bankrupted the financial system and forced the government to step into the breach.

After the disaster in the early 1990s, LBOs went out of fashion and these LBO Firms renamed themselves as Private Equity Firms, known as PE Firms today. And they renamed the Junk Debt they used to Below Investment Grade Debt, better known as High Yield Debt. Thus, they arose once more reborn like a Phoenix, after the requisite period of penance. Investor memories are short. And the sins of the past tend to blow away as they focus on the next great opportunity. Thus, Wall Street tends to rename products that blow up to disassociate the product from the disaster they caused. The product remains the same, just the label changes.

Let us fast forward to today. Private Equity Firms continue on their quest to take over the world. Today, PE Funds control over 28,000 companies that total $3.2 Trillion in Assets. In addition, these firms possess over $2.6 trillion in "Dry Powder" to deploy in deals as of the end of 2023. Dry Powder means that investors committed this amount of capital that the PE Firms can "call" to pay for a deal. The problem stands the time frame in which they must deploy the capital. Most fund documents require the capital deployed within 3 Years. This prevents the PE Firms from sitting on the capital and the investor possessing a legal obligation to produce the capital forever without possessing the ability to deploy it elsewhere. With 26% of this Dry Powder held 4 Years or more, a portion of this Dry Powder may evaporate into the ether. This especially may occur due to the Mexican Standoff between the prices at which PE Firms wish to deploy capital and asset values in the marketplace. After a decade of falling interest rates, care of the Federal Reserve, asset valuations stand at high levels historically. The falling interest rates benefited PE Firms on the way down, as the assets they bought saw their valuations expand, whether or not the firms added any value.

However, the tide turned, with inflation and higher interest rates, over the past two years. Just as occurred on the way down, with rates headed up, asset valuation adjustments to the changing cost of capital lag. Investors need to believe these changes stand permanent before adjusting valuations. This make it difficult for PE Firms to leverage the assets the way they would desire as credit from banks and investors proves more costly. And with the same amount of debt consuming more of the cash flow, creating value for the Equity Investors becomes difficult. In other words, the math does not work. Reflecting this, purchased deal value fell almost 36% in 2023.

In addition to impacting the PE Firm's ability to enter into purchases, higher interest rates impacted their ability to exit. In 2023, exits totaled $345 billion, down 44% from the $613 billion in 2022 and down 66% from 2021. This means it would take at least a decade to exit their portfolios at the current rate or well beyond the life of most funds. The following example indicates the issue facing these funds:

	Exit at 5% Financing	***Exit at 7% Financing***
Cash Flow	*$10 million*	*$10 million*
Debt Coverage	*3.0x*	*3.0x*
Maximum Interest	*$3.33 million*	*$3.33 million*
Maximum Debt	*$66.6 million*	*$47.6 million*
Equity at 35% of Capitalization	*$35.8 million*	*$25.6 million*
Total Capitalization	*$102.4 million*	*$73.2 million*
Debt to Cash Flow	*6.66x*	*3.70x*
Total Cap to Cash Flow	*10.2x*	*7.3x*

As this simple example makes clear, the rise in rates significantly impacted the value of these companies and the ability to sell these companies at anything resembling the original promises made to investors. In effect, a rise in rates of just 2% cuts the value of these entities for an exit by almost 30% in a leveraged transaction. And if the calculations take into account a 4% rise, similar to what occurred in the markets, then the drop in value exceeds 40%.

To understand what kind of impact this could mean for some recent vintages, the life cycle of a Fund stands a key consideration. Typically, a fund deploys most of its capital in Years 1 to Years 3. It then returns capital to investors. A critical measure for investors stands the amount of capital they have received back relative to the capital deployed and relative to the Valuation put forth by the Fund's sponsor. The following table provides some data from recent Vintages:

Year	***Paid In To Committed Capital***	***Total Value***	***Distributions To Paid In Capital***	***Remaining Value***	***Remaining Value as % of Total Value Plus Distributions***
2018	*0.98x*	*1.57x*	*0.36x*	*1.21x*	*77%*
2019	*0.90x*	*1.48x*	*0.23x*	*1.25x*	*84%*
2020	*0.78x*	*1.35x*	*0.08x*	*1.27x*	*94%*
2021	*0.58x*	*1.16x*	*0.00x*	*1.16x*	*100%*

Data care of JP Morgan as of Q2 2023.

The valuations for these funds, in the above table, relies on data as of mid-2023. For the 2018 and 2019 Vintages, in particular, most of their capital deployed during a once in a generation point for Interest Rates. And, based on industry data, PE Funds paid 11.0x EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), on average, for their acquisitions. The last time rates stood at 2024 levels, pre-2008, PE Funds paid much lower entry prices. And even with rates not at these levels, such as in 2010, the average purchase price stood just 8.0x EBITDA, 27% lower than today. In addition according to Moody's, B- loans, one of the principal funding sources for the marginal debt on these acquisitions, stand at significant risk with over half of companies not generating sufficient cash flow to cover capital spending and debt service.

Another reality impacts the potential returns of these funds. Due to the amount of leverage utilized, the variable rate nature of the debt, and the impact of rising interest rates, the ability of portfolio companies to grow becomes diminished as rising interest expense chews up a larger portion of the cash flow leaving less money to reinvest into the business. In 2023, Interest Coverage Ratios fell to 2.4x in the US and 2.6x in Europe, the lowest since 2008. This reflects the cost of borrowing rising from 4.9% in 2022 to 7.2% in 2023, as the vast majority of debt originates in the private credit markets with floating rates. Interestingly, if interest rates remain at current levels, borrowing costs will rise further in 2024, putting more pressure on Coverage Ratios and Asset Values. Despite this, exits stand easy for successful, growing companies. They just grow their way out of the problem. But they are difficult for the less star-studded entities.

WSL Family Office &
Private Wealth Management, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087

www.wslwealth.com

Reflecting this, assets held more than four years now comprise 46% of PE Fund holdings, the largest percentage since 2012. For investors who desire their capital back with the promised returns well within the 10 Year life of a fund, this creates a problem. And with forced sales at the end of a fund's life, assets could end up sold for substantially less than desired, massively impacting investor returns and the firm's marketed Investor IRR (internal rate of return) which determines its ability to raise its next fund. For both investors and fund sponsors, this brings to the fore a series of potentially difficult issues. Thus, what's a PE Firm to do to solve both its and investors' issues?

For every problem, there exists a solution. Or, on Wall Street, there exists another way to extract fees and to make money. Thus, in this case, there were born Secondary Funds and Extension Funds. For a variety of reasons, investors may need or desire their capital back prior to the Fund's full liquidation of invested capital over a typical 10 year life plus two 1 Year extensions. The could be due to a death or divorce or some unplanned family emergency. And, as a result, the investor may need liquidity in a hurry due to circumstances beyond their control. In addition, investors may receive an opportunity to invest in another area which possesses very attractive economics and returns, that could enhance the investor's economics over the long term. Unfortunately, most funds don't allow an individual investor to pull out their money early, as they must treat all investors as equals. In addition, there exist regulatory impediments as well. To allow the investors to sell their Limited Partnership (LP) stakes at a privately negotiated price to a third party potentially creates a public market in the units and likely creates a valuation event for the firm. The former could violate SEC regulations relating to the exemption under which most funds are raised while the latter could create a problem if the fund has outside valuations that differ from the valuation implied by the sale, especially should the sale occur at a lower valuation than the official one. To solve this problem, the industry created Secondary Funds. Secondary Funds purchase LP stakes at a valuation blessed by the Fund. This avoids a valuation event. At the same time it provides investors liquidity for their illiquid stakes. Of course, the investor gives up return for liquidity. But, they do get liquidity they otherwise would not possess. Secondary Funds benefit as a PE Fund is typically fully invested at the point at which they acquire investor stakes. Thus, they can handicap the likely return profile for a PE Fund, thus lowering their risk relative to the returns they receive. While these Secondary Funds do collect another layer of fees, they provide a liquidity function for the investors in a PE Fund.

Extension Funds, in contrast, serve a different function. They effectively take on the companies that the PE Funds determine require a bit more time. In other words, they represent either the dross that they could not sell during the life of a fund or salable companies that cannot meet return objectives. These funds enable firms to close out a PE Fund without needing to dump an asset onto the market at an inopportune time or fully writing it off. Thus, the PE Fund can avoid a larger impact on the overall fund's returns. And these companies, which are typically Not Investment Acorns, get a second life. In other words, the PE Firm gets several more years to figure out how to get a return out of their investment.

WSL Family Office &
Private Wealth Management, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087

www.wslwealth.com

Lastly, another interesting phenomenon appears to have arisen with the growth of PE Funds and the massive rise in their investments. A significant portion of exits occur to other PE Funds. According to S&P Global, while sales to industry players represented ~50% of exits in 2023, more than 30% of sales processes ended with another PE Fund owning the company. In other words, an asset gets traded from one PE Fund to another. And the second owner may sell it to a third PE Fund. Companies may get "restructured" multiple times along the way. Eventually, the company may get sold to an outside the system entity at an opportune time.

For PE Firms, the rise in Interest Rates represents a secular shift. As The Tide Goes Out, no longer can these firms heap loads of debt on the portfolio companies in the expectation that they can sell them at a higher price to a third party as rates fall and valuations rise. Instead, they will need to drive fundamental growth that supports a rise in a individual portfolio company's value. And this will require a different set of skills than those that led to success over the decade from 2011 – 2021. In effect, they will truly need to become Owners of the companies, invested in their future success, a success built on people and investments into these companies. And for those unable to make this needed transition, all that can be said is: Oh, Those Poor Private Equity Firms.