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Lenders Absorbing More Risk in LBOs These Days

BY LLOYD GREIF

The current buyout binge by private equity investors has been duly noted in the business press. Tales of such investors paying themselves hundreds of millions of dollars in a single deal aren't uncommon.

But lost in this flurry of publicity is the fact that the lenders who provided the financing for these transactions are often left holding the bag. The refinancing that makes it possible for private equity investors to pay themselves huge dividends subjects lenders to risks that can have near-catastrophic consequences for the banking system and the economy.

It's not as though this is the first time there's been such a boom in private equity purchases. A similar wave swept through the United States in the '80s, and the economy survived, though with a few casualties. Remember the dark days of the early '90s in the financial services industry?

But the dealsmanship of today is much different than it was then.

In that heyday of the leveraged buyout, deals were being completed with very little equity provided by financial buyers. Banks and institutional lenders were putting up 90% to 95% of the purchase price; private equity firms were cutting themselves in for as little as 5%.

Today those percentages are much different. Typically, private equity investors are getting into deals by investing 25% or even 40% of the price. Lenders are comfortable financing the balance, which usually is much less than what they were providing two decades ago.

Why worry? One cause for concern stems from the fact that competition among lenders to finance leveraged buyouts is more intense than ever. As a result, lenders are being much more liberal these days in lending against cash flow. Just a few years ago, they seldom advanced more than two to three times cash flow, a conservative multiple. Now it's not unusual for banks to lend five to six times cash flow.

With that kind of leverage, everything must go exactly as planned to avoid problems. And, of course, it's rare that a deal doesn't encounter a few glitches. But the greater cause for concern is that private equity firms are taking out most or all of their equity much earlier than they were in the '80s, often within 12 months of a transaction's closing.

Banks are willing to oblige them, providing the requisite increased financing for these so-called dividend recaps, because it enables them to profit from the deal a second time.

And where does this leave the banks? After the private equity investors take all of their money off the table, the company is effectively 100% leveraged, and the banks are the only ones left with a stake in it. If the company runs into any problems or if the economy softens, there's nothing to prevent the private equity firms from walking away and saying to the banks, in effect, "Here's the key."

It's like refinancing the mortgage on a house to the point where the owner no longer has any equity in it. If property values suddenly drop, the owner's reaction usually will be to abandon it.

Obviously, if enough private equity deals turn sour, there could be a severe strain on the banking system. Worse yet, there likely would be a ripple effect through the economy as companies declare bankruptcy or, at best, tread water and forgo growth. They won't be able to invest in new plants, new equipment or new products, because all of their earnings will be diverted to pay off debt.

The result could well be a jolt to the system, manifested in widespread layoffs.

All of this may seem like a doomsday scenario to some, but it is far from inconceivable.

What can be done to avert such a calamity?

First, all of us in the fields involved—investment banking, commercial banking, and private equity investing—must look beyond the fact that these are very good times for us. We have to realize that we have a social responsibility to exercise discipline so that things don't get out of hand, as they have in previous leveraged buyout cycles.

Lenders bear a disproportionate share of this burden, because they are the ones letting the problem develop. The greed factor has kicked in as lenders see that they can collect fees not just once or twice, but sometimes several times from refinancing leveraged buyout deals over and over again.

If we don't take preventive measures, the government may step in. At present, of course, private equity investing lies outside the purview of regulation. But if the government sees the situation tumbling into chaos, it could easily extend its reach to include private equity deals.

Some might argue that a self-disciplining system already exists. If a private equity firm disappoints the institutional investors and high-net-worth individuals who back its funds, those investors will withdraw what's left of their money, if possible, and they certainly won't be eager to invest in future funds of that firm.

But that system won't prevent lenders from suffering big losses when a deal doesn't work out. It's imperative that all parties involved in highly leveraged transactions work together to guard against the day when we might have to admit that Chicken Little was right.

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