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The Second Coming of LBOs

With share prices tanking, leveraged buyouts are looking more lucrative, though not nearly as much as in the '80s

For now the barbarians at the gate are quiet. But this calm probably won't last. With the markets in a deep swoon, leveraged-buyout firms could soon be on the prowl again, hunting down companies with renewed abandon. LBO powerhouses such as Hicks, Muse, Tate & Furst and Blackstone Partners have been raising record amounts of money in recent years. In 2000, LBO firms took in a total of $63.3 billion, according to Venture Economics, a private equity research firm. Now these buyout companies have to invest their money somewhere.

"Public markets right now are extraordinarily attractive," said Scott Sperling, managing director at Thomas H. Lee & Co., a Boston-based LBO firm. "There are a lot of good growth companies whose stocks have been hammered very hard. That means management teams are frustrated over where their stocks are trading. It all adds up to a situation where a lot of these companies will do one of two things: Go private or sell off subsidiaries or divisions."

SKITTISH LENDERS. But when the hunt begins, it won't be like the wild and woolly days of the 1980s. The high-rate of junk-bond defaults and a cooling economic environment have made lenders skittish about issuing new debt. This has posed an obstacle for LBO firms, which specialize in buying companies using debt as payment.

In the late 1980s, LBO firms sometimes bought companies with nearly 90% debt and 10% cash. But debt-to-equity ratios in leveraged deals have sunk to about 2 or 3 times equity, down from about 4 times equity last year. The question now is whether today's deals will earn anything close to the lucrative returns of yore. Over the past 10 years, LBO firms posted an average annual return of 16.6%, and top performers have been known to turn in results topping 30%, according to Venture Economics.

Still, signs are that the debt market is improving. Investment-grade bond issuance through February is off to a strong start at $108.6 billion, up from just $47.7 billion in the same period last year, according to Moody's Investors Service. New junk-bond issuance so far this year is also higher -- $25.7 billion, vs. $15 billion in the same period of 2000. "As the debt market rebounds, we will see more deals in the second half of the year," predicts Ed Imbrogno, co-head of private equity coverage at First Union.

PLENTIFUL TARGETS. Banks are starting to get more comfortable with financing leveraged deals as the stock market appears close to a bottom, notes Lloyd Greif, president of Greif & Co., an investment banking firm that works with private equity firms. And targets should be plentiful as LBO firms search for attractive investments among depressed stocks and undervalued assets. "Taking public companies private will be increasingly in favor this year, a 100% increase easy," says Greif.

So what will the LBO landscape look like? All told, 19 major public-to-private transactions were executed in 2000, according to Thomson Financial Securities Data Merger & Corporate Transactions Database. Among them: Silver Lake Partners' $20 billion buyout of disk-drive maker Seagate Technology. Already this year, Forstmann Little recently agreed to buy Citadel Communications Corp., a regional operator of radio stations, in a deal valued at $2 billion.

The type of deals that predominate this year, however, will be much less tech-focused. It's back to traditional industry for the LBOs. In the last couple of years, some buyout meisters got caught up in the high-tech frenzy and started dabbling in venture-capital-style investments in dot-coms and cyber-companies.

SOUR INVESTMENTS. But the big pension funds, university endowments, and insurance companies that mainly finance the LBO firms wagged their fingers when a lot of their investments went sour. Now they want LBO firms to return to tried-and-true leveraged strategies. That will favor plays in manufacturing, consumer products, food, and financial services, among others. "While tech and telecom were going crazy, Old Economy [stock] prices stayed at very depressed levels," says Imbrogno. And with earnings going soft, few catalysts other than LBOs or mergers can drive up share prices.

Another lucrative source of deals will be small companies that Wall Street investment banks don't bother to cover. "These represent great partners for buyout firms that would take them private," says Chris Redmond of A.G. Edwards Capital. He estimates there are some 300 smaller companies of interest to LBO firms at the moment.

CASTOFFS, AHOY! Technology deals, when they occur, will be more conservative than in the past few years. LBO firms know they'll have to prove to their lenders that the buyout target isn't a cash-guzzling loser. "When the technology concept is proven and a lender can have some confidence in the sustainability of cash flows, it could be appropriate," Redmond said.

Another option is buying corporate castoffs. Alec Gores, CEO of the private LBO firm Gores Technology, says his firm has made a killing by scooping up noncore, money-losing tech subsidiaries from big companies. For example, the firm bought The Learning Company from Mattel in late September and restored the struggling consumer software maker to operating profitability in less than six months, by stripping out noncore businesses, reducing operating costs, and centralizing processes.

Buyout mavens contend that an LBO often can be a boon for existing shareholders. Sam Fox, chairman and CEO of Harbour Group, a private equity firm that specializes in acquiring small manufacturing and industrial companies, has been actively shopping for public-to-private deals with the aim of working closely with acquired companies out of the critical eye of Wall Street.

"UNLOCKING VALUE." "If we take a company private, there's a real benefit to the shareholder. When shareholders are locked into an undervalued company, in many cases, the stock is almost illiquid. If we make an offer, it's unlocking value in the company and giving [shareholders] liquidity."

In short, LBO firms face tougher conditions than in the halcyon buyout days of the 1980s. And returns probably will be lower this time around. But the barbarians are gathering at the gate, anyway. And it won't be long before they start making some noise.

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