New Wall Street Buyout Tool Seen Carrying Risks
Reuters
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NEW YORK - In their eagerness to participate in the biggest buyouts, Wall Street banks are committing more of their own capital up front, a practice that carries significant risks if markets drop.

Texas's largest utility, TXU Corp., agreed on Monday to be acquired by buyout giants Texas Pacific Group (TPG) [TPG.UL] and Kohlberg Kravis Roberts & Co. (KKR) [KKR.UL] for $32 billion. The largest-ever leveraged buyout (LBO) will require investment banks to underwrite about $24 billion in debt.

Beyond that, the investment arms of merger advisers Goldman Sachs Group Inc., Lehman Brothers Holdings Inc., Citigroup and Morgan Stanley agreed to invest about $7 billion of equity in the transaction.

And in a growing trend, Morgan Stanley, Citigroup and JPMorgan Chase & Co. extended an additional $1 billion as an "equity bridge."

Wall Street firms are on the hook to sell this equity to other firms, hedge funds and wealthy individuals.

When markets are booming, Wall Street firms can earn lucrative commitment and other fees from distributing these stakes. Extending bridges also help firms boost their stature among clients and keep them in the inner circle of LBO advisers.

The problem is if a deal breaks down or the broader markets drop -- as they did on Tuesday with the Dow industrials plunging 416 points -- the banks could be stuck holding the bag.

"When the music stops, somebody is not going to have a chair to sit in," said Colin Blaydon, director of the Center for Private Equity and Entrepreneurship at Dartmouth College's Tuck School of Business.

QUICKLY AND QUIETLY

Private equity firms are in a golden era, raising record levels of capital from investors clamoring to capture exceptional returns. TPG, KKR and other LBO firms also hold enormous sway on Wall Street, since they generate many of the biggest deals, pay billions in fees and create demand for follow-on debt and investment opportunities.

The equity bridge has emerged as a tool that lets LBO firms put together blockbuster deals without having to bring in lots of rival firms. That ability to move more quickly and quietly has taken on greater significance amid a federal investigation into whether LBO firms have colluded to cap takeover prices.

Blackstone Group earlier this month struck an agreement for a $23 billion buyout of Equity Office Properties, a deal that included a bridge equity commitment.

Bridges are one of several strategies that LBO firms use to trim their own financial exposure even as they hunt bigger game.

In the TXU deal, for example, TPG and KKR have each committed about $2 billion to the deal, according to people familiar with the situation.

Based on other recent deals, LBO shops can distribute one-half of that stake to their limited partner investors, who are often eager to get the opportunity to invest alongside the buyout funds. Wall Street banks further lighten the load by investing alongside the LBO firms.

But banks, who declined to comment for this story, now are taking on a higher level of risk by extending bridge equity.
These commitments are a descendant of bridge loans, which assured clients that funds needed for a deal would be delivered.

If the lenders could not find outside takers for these loans, funds came out of their own pockets. Such commitments led to significant losses on Wall Street after markets tumbled in the late 1980s.

One veteran buyout lawyer, who requested anonymity, noted that even today, any number of things can happen between a deal announcement and the closing.

"These equity bridges are totally terrifying, not from the point of view of the private equity firms, but for the investment banks," the lawyer said.

That's because if a deal falls apart, then the bridge bank must take on the equity stake -- usually under the worst possible conditions.

Some banks are reluctant to make such commitments.

Asked during an investor meeting if the TXU deal points to market excess, Bank of America Corp. Vice Chairman Gene Taylor said, "The answer is, 'Yes,' There are transactions that cause us to pause."