Are leveraged buyouts worth the risk?: Crossing from public to private carries high rewards, dangers

America is in the midst of a leveraged buyout boom as a rapidly growing number of public companies come under the control of private owners.

With deals announced nearly every week, including for big names such as casino giant Harrah's Entertainment Inc. and hospital operator HCA Inc., some may wonder what all the fuss is about.

After all, what difference does it make if a private equity firm owns a company instead of hundreds of thousands of shareholders around the country?

The answer: a lot.

In general, private equity firms, once known as leveraged buyout firms, help companies grow faster and become more efficient, buyout experts say. Steven Kaplan, a finance professor at the University of Chicago Graduate School of Business, has found that companies that get bought out are more profitable.

On the flip side, most of the companies that get taken over wind up carrying huge amounts of debt. In general, the private equity firm puts in little cash to finance the deal, and the company that's acquired bears the debt.

"If there is a significant economic slowdown, with the amount of leverage put into these buyouts, the companies will not be able to meet their interest payments," said Fred Wainwright, executive director of the Center for Private Equity and Entrepreneurship at Dartmouth College.

"Anytime you increase leverage, you increase risk."

This downside could have important ramifications for the economy should a recession occur.

For now, though, the deal-making is reaching record levels. More public-to-private transactions have occurred in the last 18 months than in the previous 18 years, James Coulter, managing general partner of Texas Pacific Group, said at a conference last month.

The money is pouring into private equity firms from pension funds, insurance companies, college endowments and other institutional investors looking for higher rates of return than they earn in traditional investments such as stocks and bonds. The availability of
cheap debt from banks has also played a role in financing big deals.

Buyout firms have come a long way from the 1980s, when they were called raiders because they acquired conglomerates, sometimes in hostile takeovers, and sought to increase value by breaking them apart.

In the 1990s, buyout firms softened their public image by purchasing companies and expanding them through a series of acquisitions, a strategy known as "buy and build."

Today, some buyout firms have come under criticism for piling debt on the companies they acquire in order to pay themselves hefty dividends. A few are also selling companies after a year or less of ownership, a practice known as flipping. These once unheard-of strategies aren't widespread, but they're becoming more common.

Robert Bruner, dean of the Darden Graduate School of Business at the University of Virginia, said some bankers fear the bought-out companies will wind up on bankruptcy lists in the next major economic downturn.

But overall, he says the buyout boom is positive.

"These companies tend to become much more efficient," he said. "We are all better off if businesses run more efficiently."

We decided to look at the effect of a leveraged buyout on two local companies. Here's how they fared:

Neiman Marcus Inc.

A year after buyout firms Texas Pacific Group and Warburg Pincus LLC took Neiman Marcus Inc. private in a $5.1 billion deal, the Dallas luxury retailer's sights are squarely set on growth.

It is planning to add more than 660,000 square feet of store space over its next four fiscal years, a 12 percent increase from current levels. It wants to expand its 38 Neiman's stores to 50 or more, increase the number of Last Call outlet stores from 18 to 30 and launch a clearance merchandise Web site next year.

Neiman Marcus has also opened two pilot stores called Cusp that sell contemporary apparel, handbags and shoes geared toward younger women. Two more are on the way.

With record sales of $4.1 billion in its fiscal year that ended July 29, Neiman's didn't need radical restructuring. Instead, its new owners worked with Neiman's management team to do a long-term strategic review of the company. That led to stringent strategic and operational goals for management to meet.

"The company has always been a well-run company," said Jonathan Coslet, a
Neiman Marcus director and Texas Pacific Group senior partner. "All we tried to do was reinvigorate and inject a sense of energy and enthusiasm over growing the business."

The buyout firms are pushing management to be more aggressive about where it opens stores, Mr. Coslet said.

And Texas Pacific also set up meetings between Neiman Marcus and the executives of another chain it owns a stake in, J. Crew Group Inc. Both retailers are trying to integrate catalog and store businesses to boost sales.

But most of Neiman's operating cash flow is being used to pay down its $3.2 billion of debt. A more than 17-fold jump in interest payments due to its hefty debt load resulted in a 77 percent drop in net earnings for fiscal 2006.

But by keeping a tight rein on costs, its margins should improve this fiscal year, Mr. Coslet said.

For now, the biggest danger for Neiman's would be an unexpected slowdown in luxury consumer spending. Luxury retailers had a few nervous months after 9/11, for example, but sales rebounded. But with millions of affluent baby boomers entering their prime spending years, Neiman's profit potential far outweighs the risks.

"The wind is generally at Neiman Marcus' back," Mr. Coslet said.

Celanese Corp.

Private equity ownership has had a far more dramatic impact on Celanese Corp., a Dallas-based industrial chemicals giant.

The producer of acetic acid, liquid crystal polymers and other products spent only nine months under the ownership of the Blackstone Group. But during that time, Celanese moved its headquarters from Germany to Dallas, laid plans for two acquisitions that occurred last year, expanded its operations in China and restructured some of its businesses.

It closed and consolidated a few factories, which cost nearly 600 U.S. jobs.

These kinds of moves would have been more difficult as a publicly traded German company because of stricter laws and regulations, said David Weidman, Celanese's chief executive and president.

The buyout deal was controversial in Germany, where unions and others have linked takeovers by foreign investment firms with job losses. The buyout was also criticized by hedge funds that were unhappy with the terms of the deal.

But since Blackstone bought control of the chemicals producer, Celanese's sales have
risen sharply. Its capital expenditures and research and development spending have stayed constant. And its operating profit has soared, thanks to higher prices and productivity improvements.

The deal did load Celanese with $3.3 billion in long-term debt, but Mr. Weidman believes the company's strong cash-generating abilities will enable it to meet its interest payments even if market conditions turn unfavorable.

"I don't lose a lot of sleep over that," he said.

In January 2005, Celanese went public again, this time as a U.S. company. Blackstone still owns a 32 percent stake.

Most of the proceeds from the company's initial public offering went to pay a special cash dividend of $804 million to Blackstone. The Daily Deal estimated that Blackstone raked in $2.3 billion altogether from its investment in Celanese.

Today Mr. Weidman defends the company's sale. "Private equity was a way for us to execute the strategy faster and more effectively," he said.

"I can't emphasize enough how essential Blackstone was at a critical point in our strategy."

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A TALE OF TWO COMPANIES

Neiman Marcus and Celanese made major moves after going private. But the debt they took on adds risk as well.

NEIMAN MARCUS

Taken private by Texas Pacific Group and Warburg Pincus on Oct. 6, 2005.

CELANESE

Taken private in April 2004 by the Blackstone Group and went public in January 2005. Blackstone currently owns a 32 percent stake.

Celanese has said a switch to a new basis of accounting makes results after the buyout not comparable with those before the ownership change.

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