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As buyouts continue, when is it a bid too far?

News of numerous buyouts of companies, some costing tens of billions, has been reported recently. May went down as a record, with $115.5 billion in private equity deals announced.

Buyout firms, with large sums of money in hand and more being pushed their way, are paying higher and higher prices to acquire companies. Is this the sign of a market top? And where is all this money coming from? Are investors really diversifying their portfolios?

In recent years, institutional investors in particular have dedicated increasing portions of their portfolios to so-called private equity firms, an omnibus title covering hedge funds, and what used to be called leveraged buyout (LBO) firms.

It started in Oregon

LBO firms have been around for some time. One of the first was Kohlberg Kravis Roberts (KKR), which pioneered the concept, then called "bootstrapping." With the aid of fellows like Michael Milken, LBOs gained lots of traction in the late 1970s and early 1980s.

The state of Oregon's pension fund was one of the first pension funds (probably the first) to invest in such vehicles, and it became not only KKR's first public fund investor but also one of its largest investors of all. Following the Oregon investment, the state of Washington also invested in KKR but on a smaller scale. These investments gave KKR credibility among pension funds.

One of KKR's first investments was the buyout of Fred Meyer, right in our own backyard. Another local investment was Red Lion. The Fred Meyer investment was particularly rewarding for investors, and the state pension fund prospered as a result. Many investments followed, with KKR raising subsequent and larger funds with similar outsized returns.

SUMMING IT UP

William Rutherford

Imitators followed, and today there are numerous firms, now called private equity firms, with massive funds ready to be deployed. KKR was really the only game in town until the buyout of RJR Nabisco, which turned out to be a big disappointment. The buyout became the subject of a best-selling book, "Barbarians at the Gate," and a movie. The disappointment over Nabisco took the patina off KKR and opened the door to other firms competing in the same space. That transaction was, truly, a bid too far.

Deal may have been precursor to crash

The crash of 1987 came on the heels of the Nabisco buyout. And although the Nabisco buyout did not cause the crash, it may have been a precursor because of the excesses it demonstrated.

As the economic recovery ensued, and with KKR's eminence lost, many other firms entered the now-renamed-private equity space. Institutional investors began to find investments in this area profitable as the economy surged. Staid investors such as the Harvard endowment began to invest billions. Today, it's hard to find institutional investors that do not have targets of at least 50 percent or more for investments in private equity, hedge funds and the like. Private equity firms now find themselves raising funds that were beyond the imagination of just a few years ago, and no firm seems too big to be acquired.

All this activity has had a heady effect on the markets. All eyes are on the next buyout opportunity and its chance for a quick profit. Companies are mindful they may be the next target, which can bring a nice payday, but what about the other stakeholders in the company: the employees, suppliers and communities where the firms are headquartered?

Some firms, in an effort to preserve their independence, have taken to buying back some of their own shares to boost stock prices and earnings. Sometimes this has the effect of steering capital from investment in the business to the stock buybacks, and perhaps sowing the seed for longer-term disappointment. Since there is so much money available to private equity firms (some are even turning money away), the firms have little constraint on their activities. (The liquidity comes from the aforementioned institutional investors, liquidity generated by

When companies acted as leveraged buyout firms, they at least had to get bank loans or pass bondholder scrutiny. But now there are no such constraints, and indeed after the buyout they often saddle the acquired company with new loans to pay themselves and their investors a dividend. One can only wonder how this movie ends. How will we know when it is a bid too far?

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operating companies, new financial tools, the Yen carry trade and China.)

When they acted as LBO firms, companies at least had to get bank loans or pass bondholder scrutiny (even though they were junk bonds, they had to be sold). But now there are no such constraints, and indeed after the buyout they often saddle the acquired company with new loans to pay themselves and their investors a dividend. One can only wonder how this movie ends. How will we know when it is a bid too far?

Some take comfort in the notion these investments are not correlated with the overall market, but how disconnected from the economy and the markets can they be, especially as the targets of acquisition become major firms? This phenomenon bears close watching, and no doubt we will revisit it in future columns as the story unfolds.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar for its three- and five-year returns. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact Rutherford at 888-755-6546 or on the Web at www.rutherfordinvestment.com.