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LBO Shops Follow Apollo's Lead On Publicly Traded Debt Funds

Low Interest Rates Made Trend Possible. Will It Last?

By Sree Vidya Bhaktavatsalam

General partners have been flirting with the public markets for years. Now the relationship has gotten a lot more serious.

Apollo Advisors, New York, got the ball rolling early last month, raising $930 million through the public offering of what is known as a business development company, or BDC. The money is intended primarily for senior and subordinated debt investments in mid-sized private companies.

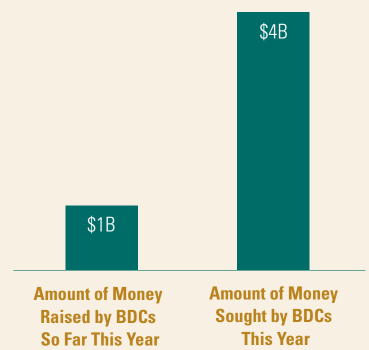
Since then seven more buyout firms, among them New York-based **Blackstone Group**, **Kohlberg, Kravis, Roberts & Co.**, and **Kelso & Co.,** have set out to raise upwards of $4 billion through similar offerings of BDCs (see table on page 67). Sources say that **Thomas H. Lee Partners,** Boston, and **Texas Pacific Group,** Fort Worth, Texas, may not be far behind.

"It's quick-and-easy capital for private equity firms," says Marco Masotti, a partner at law firm **Paul, Weiss, Rifkind, Wharton & Garrison LLP.** "And based on Apollo's experience, there seems to be some real investor appetite out there."

It would be tempting to call this a revolution in the way general partners raise and manage money. Perhaps it will turn out to be the start of one. But for now, it does seem to us largely a natural step in the maturation of the leveraged lending markets that finance buyout deals.

Though not household names, **Allied Capital,** Washington, D.C., and **American Capital Strategies,** Bethesda, Md., over the years have raised a total of more than $5 billion from public markets in large part to make senior debt and mezzanine investments. Allied Capital has been raising such funds for the last four decades, American Capital Strategies since 1997.

Pipeline of BDCs*



*Includes those business development companies that make private equity-related investments

Sources: Securities and Exchange Commission and The Private Equity Analyst

By investing in Allied Capital and American Capital Strategies, mutual fund managers, hedge fund managers and other institutional investors have been supplying a growing percentage of the senior debt and mezzanine debt used to finance leveraged buyouts. They've also done so by backing privately placed collateralized debt obligation (CDO) funds earmarked for similar investments. Such funds, not coincidentally, are raised and managed by many of the same GPs heading out to raise BDCs.

All this money flowing into the buyout market is one reason that the leveraged lending markets have held up so well, even as banks continue to consolidate at a furious pace. Now, through these BDCs, general partners are trying to drill even deeper into the same institutional well supplying capital for CDO funds. They are also trying to expand their investor base to include retail investors.

Just how large this wave of BDCs will become is a matter of some debate. For now, there are the fee-minded

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investment banks like **Citigroup, JPMorgan,** and **UBS Investment Bank** promoting the idea to buyout firms. With interest rates low, there are the hedge fund and mutual fund managers hungry for paper that carries a decent yield (and hedge fund managers can leverage their returns even more). Additionally, there are retail investors eager for a way into exotic private equity deals. And there are general partners ever on the lookout for new sources of capital.

But interest rates have already started to tick up. And it doesn't take too much imagination to predict that BDCs will come to be seen as a fleeting sign of the times—boom times, that is, for the LBO markets.

That said, the buyout market is likely to feel the impact of these investment pools for some time. The money flooding into mid-market mezzanine and senior debt investments is inevitably going to drive down returns in those areas. Firms that raise private limited partnerships devoted to mezzanine investing will find it harder than ever to achieve the high-teens returns they like to promise investors.

On the bright side, leverage multiples are likely to continue their ascent. But even that could eventually come back to haunt buyout firms. "The concern as we move from a tight credit cycle to good times is that firms are increasing the level of financial risk," says David M. Brackett, managing director at **Antares Capital Corp.,** a Chicago mid-market lender. "If you look back at what happened in 1998, that's what got the market into trouble."

From CDOs to BDCs

In the late 1990s, a number of firms were trying to take advantage of the expertise they had acquired on the principal investment side of the business to expand their assets under management.

Among the firms that raised captive subordinated debt funds to finance their own buyout deals were **Forstmann Little & Co.** and **Welsh, Carson, Anderson & Stowe** both of New York; **GTCR Golder Rauner,** Chicago; and **Summit Partners,** Boston.

Blackstone Group, **Credit Suisse First Boston Private Equity,** and **Goldman Sachs & Co.** were among those that raised third-party mezzanine funds to back deals financed by other buyout firms. At least five firms raised CDO funds earmarked for private placements in a variety of debt and equity securities: Apollo, Boston-based **Bain Capital,** Blackstone Group, Kelso & Co., and **JPMorgan Partners,** New York.

Blackstone, which raised a $1.14 billion mezzanine fund in 1999 and 2000, and manages some $2 billion through a family of CDO funds, started exploring the option of raising a BDC late last year. It did so in part because it has become so difficult to generate mezzanine returns in the high teens, according to sources familiar with the matter.

Blackstone's 1999 mezzanine fund had generated a net IRR of just 0.7 percent as of last September, according to data from **California Public Employees' Retirement System.** (CalPERS, however, does not consider return data is meaningful for a fund so young.)

Blackstone no longer plans to raise any mezzanine limited partnerships, Securities and Exchange Commission filings show. Instead, the mezzanine group's co-founders, Howard Gellis and Salvatore Gentile, plan to turn their attention to managing the proposed BDC.

Apollo Advisors raised a family of CDO funds under the "Ares" name, although **Ares Management**, which invests in distressed debt and high-yield bonds, is now independent. Apollo's founding partner, Michael Gross, will lead the firm's new BDC, along with Arthur Penn, who heads its distressed debt business. Both men will continue to invest Apollo's other funds, along with managing the new fund.

For its part, Ares Management, which was founded in 1997 by a group of former Apollo executives, has raised roughly $3.8 billion for investments in high-yield bond funds, senior secured loans and distressed debt. The Los Angeles-based firm is also trying to raise a BDC. (Additionally, Ares expects to hold a $750 million close in the next few months on its first control-style distressed debt fund.)

Beginning in 1998, Kelso & Co. raised some $3 billion for a series of CDOs together with New York-based **Blackrock Investors.** In 2002, Kelso hired **Credit Suisse First Boston** to market a $500 million mezzanine fund. But it ended up pulling the plug on the fund, and now plans to raise a $750 million BDC, according to sources familiar with the matter.

The earliest pioneers of debt-oriented BDCs, American Capital Strategies and Allied Capital, have never raised traditional buyout funds.

Both firms have always used the publicly traded BDC structure to invest in the senior debt and subordinated debt of mature companies, and to a lesser extent, in the equity of those companies. The structure lets them borrow up to the same amount they raise in a public offerings in order to leverage their investments.

"We noticed that these firms have a significantly lower cost of capital," says a partner at one buyout firm that has filed to take a BDC public, speaking to us on the condition of anonymity. “They were able to compete much better in the marketplace.”

American Capital Strategies says that it has generated an annualized return of 23 percent to shareholders that invested at the time of its IPO in 1997, provided the shareholders reinvested all of their proceeds. Using the same criterion, Allied Capital says it has generated an 18.3 percent annualized return for shareholders that invested in its IPO more than four decades ago.

‘Stubbornly Low Interest Rates’

Why BDCs have become so popular is still hard to pinpoint. But sources say that low interest rates and heavy demand for debt financing by acquirers are the dry powder; Apollo’s successful offering is the spark.

Low interest rates mean that institutional investors have fewer places to turn for the high-yielding paper they crave. “The biggest driver for the recent spate of BDCs has been the stubbornly low interest rates,” says Robert C. Kelley, an assurance partner with **Pricewaterhouse-Coopers Investment Management Industry Group.** “Firms want to get in front of this, and don’t want to be too late to the party.”

There should be no shortage of opportunities to put the BDC money to work. Buyout firms have seen firsthand how difficult it has been for acquirers of mid-sized companies to obtain debt financing, particularly mezzanine debt. For a variety of reasons, the limited partnership format hasn’t been conducive to raising mezzanine funds.

Washington State Board of Investment, for example, stopped investing in mezzanine partnerships in 2002 because the returns were not “adding value to the private equity portfolio,” says Executive Director Joe Dear.

Once Apollo managed to raise $930 million for its BDC, rival buyout firms quickly keyed in on the attractive fees the firm charges on the fund—a 2 percent management fee and 20 percent of all capital gains, plus 20 percent of any other income. Other firms were also impressed by the mere 12 days Apollo needed to raise the money.

Of course, buyout firms need to reflect on the risks associated in raising money on the public market—including opening themselves up to greater scrutiny by the SEC at a time when regulators are eager for a window into the private equity markets.

As managers of publicly traded companies, firms will have to file detailed quarterly reports, annual reports and proxy statements that include valuations of their portfolio companies. The annual report that American Capital Strategies files gives details about the net realized gains and losses, as well as the fair value, of each of its companies.

Buyout firms raising BDCs likewise will have to comply with the Sarbanes-Oxley Act, which requires that publicly traded companies provide more timely and detailed financial reports than before. CEOs of such companies have to certify that quarterly and annual report data is correct. Managing publicly traded funds also increases the likelihood of lawsuits.

Beyond the risks associates with public exposure, buyout firms also need to make sure they continue to devote adequate resources to managing their core funds. An investor in Apollo’s funds, for example, tell us that he is concerned about the amount of time co-founder Mr. Gross will be devoting to Apollo’s BDC.

Buyout firms are clearly making their move on the public markets. But they need to remember that hell hath no fury like an LP scorned.