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Report to Congressional Requesters

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LEVERAGED BUY-OUT FUNDS

Investments by Selected Pension Plans

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The Honorable William L. Clay
Chairman, Subcommittee on Labor-
Management Relations
Committee on Education and Labor
House of Representatives

The Honorable Marge Roukema
Ranking Minority Member
Subcommittee on Labor-
Management Relations
Committee on Education and Labor
House of Representatives

This report responds to your January 6, 1989, request that we review the role of private and public pension funds in leveraged buy-outs (LBOs). LBOs can occur in several different ways. Typically they involve the acquisition of a company whose stock is publicly traded by a group of investors who purchase the company's stock using mostly borrowed funds with the company's assets pledged as collateral. This financing technique distinguishes LBOs from other types of corporate mergers and acquisitions.

As agreed with your offices, we focused our work on pension plan investments in limited partnerships, called LBO funds, that pool capital for LBOs. Specifically, we obtained information on the (1) way pension plans evaluate LBO-fund investments, (2) principal provisions of LBO-fund limited-partnership agreements, (3) rate of return pension plans obtained on LBO-fund investments, and (4) Department of Labor's oversight of pension plan investments in LBO funds pursuant to the Employee Retirement Income Security Act of 1974 (ERISA). This report expands on information provided during our February 9, 1989, testimony before your Subcommittee.

Our work focused on eight large pension plan sponsors—four sponsoring private plans and four public plans—with over $93 billion in assets. We also reviewed the limited-partnership agreements and related documents for six LBO funds, with $7.9 billion in committed capital, in which one or more of the eight plan sponsors had invested.

In summary we found that:

- Pension plan sponsors appear to be selective in choosing the LBO funds in which to invest, and most have diversified their investments among different funds.
- Generally, the LBO-fund partnership agreements required the limited partners to pay the general partner a management fee of from 1 to 2 percent of their capital commitment during the initial years of the partnership when the general partner is identifying companies to buy.
- The LBO funds typically distribute 80 percent of the profits to the limited partners, who contribute most of the investment capital, and 20 percent to the general partners, who usually contribute 1 percent or less of a fund's total capitalization.
- Pension plan sponsors have invested a relatively small portion of their pension plan assets in LBO funds and, with one exception, have received higher returns than achieved on other plan investments.
- Department of Labor officials have not targeted LBO funds for investigation. However, they said that they would investigate an LBO fund if they received a specific allegation of an ERISA violation. Labor has conducted one such investigation, but it found no ERISA violations.

Background

The Congress has been concerned about LBOs for several years. This concern was heightened following the recent takeover of RJR Nabisco by Kohlberg Kravis Roberts & Co. for almost $25 billion.

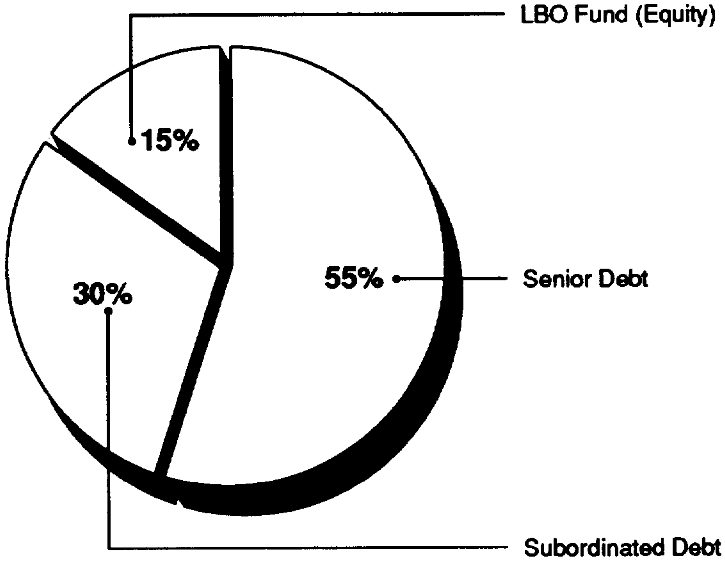
The number of LBOs has increased dramatically in the past few years—more than tripling from 99 in 1981 to 318 in 1988.[1] The dollar value of LBOs increased from $3.1 billion in 1981 to $42.9 billion in 1988. During this same period, LBOs represented between 4.3 and 9.6 percent of total mergers. However, the dollar value of these transactions as a percentage of total mergers has increased far more rapidly—from 4.6 to 18.9 percent.

LBOs are financed using a combination of debt and equity. In recent congressional testimony, the Secretary of the Treasury said that senior debt, generally supplied by bank loans secured by the company's assets, is estimated to represent about 55 percent of LBO financing. Subordinated debt (sometimes called mezzanine financing) is often provided by investment bankers in the form of short-term loans, which are usually replaced by high yield, non-investment-grade bonds (commonly

[1] Pensions and Leveraged Buyouts, Congressional Research Service, Feb. 7, 1989.

called junk bonds). The subordinated debt generally comprises about 30 percent of an LBO's total capitalization. The final 15 percent is equity, typically supplied by an LBO fund.

Figure 1: Typical Financing of an LBO



LBO funds pool capital provided by large investors, such as pension plans and insurance companies. They are formed as limited partnerships by firms that specialize in LBOs. The firms serve as the general partner for the fund. Typically, the general partner (1) finds attractive acquisition candidates, (2) negotiates their purchase, (3) arranges all financing, and (4) monitors the investment to maximize its value. The pension plans and other investors are limited partners that contribute most of the fund's capital, but are not involved in the fund's management.

Pension plans have invested billions of dollars in LBO funds. A September 30, 1988, survey by Pensions & Investment Age found that 23 of the nation's 200 largest pension plans had invested about $3.5 billion in LBO funds.[2] However, we identified several other large plans that invest in LBO funds that were not identified in this survey. Another recent survey

[2] Pensions & Investment Age is a publication on corporate and institutional investing.

found that about $3.85 billion or 1.5 percent of the assets of 88 large private pension plans were committed to LBO funds.[3]

Pension plans can also invest in LBOs by purchasing junk bonds that form the mezzanine financing portions of an LBO. One report showed that pension plans owned 15 percent of the dollar value of all outstanding junk bonds at the end of 1987.[4] Another study found that 88 private pension plans had invested about $3.4 billion or 1.3 percent of their plan assets in junk bonds.[5]

Objectives, Scope, and Methodology

In response to your request, our objectives were to determine the (1) way pension plans evaluate LBO-fund investments, (2) principal provisions of LBO-fund limited-partnership agreements, (3) rate of return pension plans obtained on LBO-fund investments, and (4) Department of Labor's oversight of pension investments in LBO funds pursuant to ERISA.

To determine how pension plans evaluate the risks of investing in LBO funds and to identify the returns pension plans have obtained on LBO-fund investments, we interviewed representatives from four of the nation's largest private pension plan sponsors and four of the nation's largest public pension plan sponsors that invest in LBO funds. Collectively, these eight sponsor 138 defined benefit plans with over $93 billion in assets.[6]

To identify the principal provisions of LBO-fund agreements, we reviewed the limited-partnership agreements and related documents for six LBO funds in which one or more of the eight plan sponsors had invested. The six LBO funds had about $7.9 billion in committed capital from all investors.

To determine the Department of Labor's efforts to oversee pension plan investments in LBO funds, we interviewed the Labor officials responsible for enforcing ERISA's fiduciary provisions concerning the investment of pension plan assets.

[3]This survey was conducted by the Committee on Investment of Employee Benefit Assets (CIEBA) of the Financial Executives Institute.

[4]Junk Bonds: 1988 Status Report, Congressional Research Service, Dec. 1988.

[5]This survey was also conducted by CIEBA.

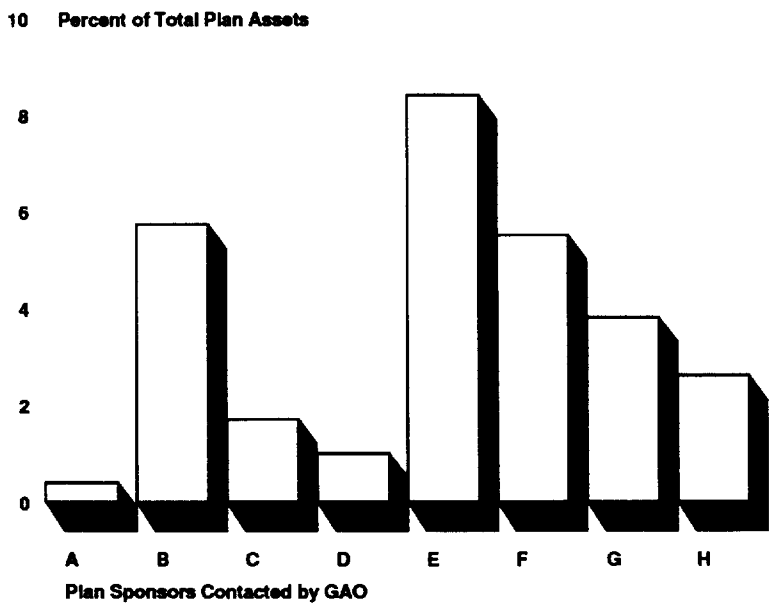
[6]Defined benefit pension plans generally provide definitely determinable benefits to participants based on such factors as years of employment, retirement age, and compensation.

The eight plan sponsors we contacted are not identified in this report, because our authority to evaluate employee benefit plans under section 11016(d) of the Single-Employer Pension Plan Amendments Act of 1986 prohibits us from publicly disclosing the identity of the plan sponsor. Similarly, we have not disclosed the identity of the six LBO-fund limited-partnership agreements the plan sponsors provided us.

Pension Plans' Evaluation of LBO-Fund Investments

The eight public and private pension plan sponsors we contacted had invested about $3.4 billion (about 3.7 percent of their combined plan assets) in 53 LBO funds. As shown in figure 2, the proportion of plan assets each sponsor invested in these funds ranged from 0.4 to 8.4 percent.

Figure 2: Percentage of Plan Assets Invested in LBO Funds



The plan sponsors labeled A through D are the private sponsors we contacted, and plans E through H are the public sponsors.

The public plans we contacted generally invested a larger percentage of their plan assets in LBO funds than the private plans. Four of the five plans with the largest percentage of plan assets invested in LBO funds were public plans.

The plan sponsors must decide to commit to the fund without knowing the specifics of any acquisition. Essentially, the plan is investing in a "blind pool," in which it does not know which company will be acquired or the price of the acquisition. As a result, a plan's evaluation of an LBO-fund investment focuses on the experience of the general partner as an LBO manager. Other factors that are examined include the investment criteria used to select acquisition targets, the minimum required capital commitment of the limited partners, profit or loss distribution between the general partner and the limited partners, and management fees.

LBO-fund investments involve several types of risk. For example, there is a liquidity risk because plan assets are committed to a limited partnership for as long as 10 or 12 years, and the partnership interest cannot be traded on the open market like stocks or bonds. In addition, an economic downturn could result in the acquired company not having sufficient funds to pay off the large amount of debt issued for the acquisition. The heavy leveraging associated with LBOs increases their vulnerability to an economic downturn or a rise in interest rates. During recent congressional testimony, the Chairman of the Federal Reserve Board estimated that roughly 40 percent of LBOs involved cyclically sensitive industries that are more likely to encounter trouble in a severe economic downturn.

Principal Provisions of LBO-Fund Agreements

The LBO-fund partnership agreements we reviewed usually described the criteria the general partner will use to identify an acquisition target. The criteria include such factors as a stable cash flow, low debt-to-equity ratio, a strong management team, a history of demonstrated profitability, products with brand names or a strong market position, and companies involved in industries not subject to rapid technological change. The LBO funds generally were to last for 7 to 12 years, with provision for the general partner to extend the fund under certain circumstances.

Two of the six partnership agreements limited the amount of capital that could be used for any acquisition to 10 or 25 percent of total capital commitments. These two agreements also indicated that they would use the capital to make between 5 and 20 acquisitions. The other four agreements did not specify the number of acquisitions that would be made. Four of the six partnerships also limited their investments to friendly takeovers—those that are not opposed by the company's board of directors and that retain existing management.

In all six funds, the general partners usually contributed 1 percent or less of total fund capitalization. In one fund, the general partner also participated as a limited partner, contributing 10 percent of the fund's total capitalization.

All of the funds were to distribute 80 percent of the profits to the limited partners and 20 percent to the general partner, but several guaranteed a minimum return on investment to the limited partners before the general partner received anything. One fund would not make the 80/20 profit distribution until the limited partners had received a return of all the capital they invested in the transaction. Three funds provided for their 80/20 distribution only after the limited partners had received a return of their invested capital plus a 12 to 30 percent return on their investment.

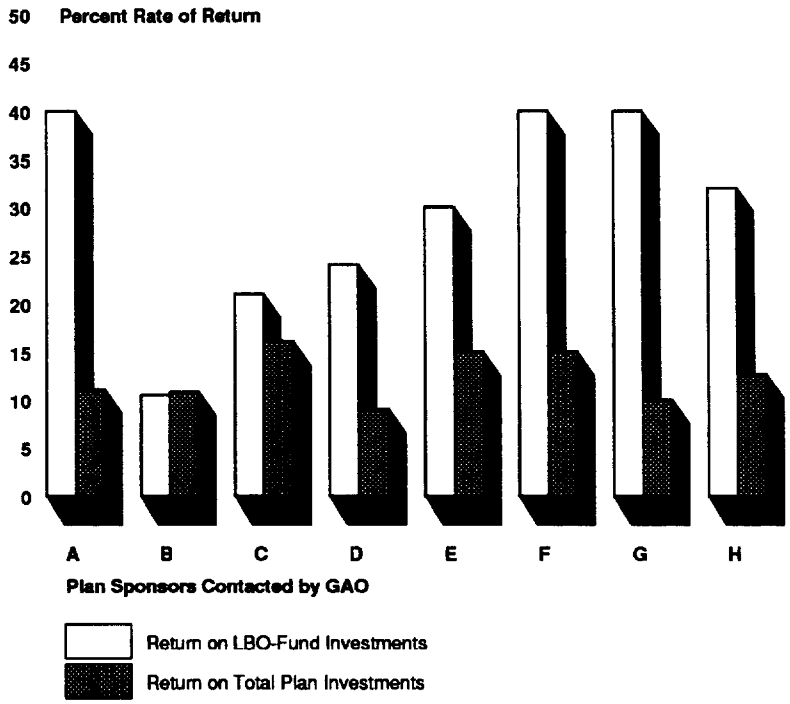
Five of the funds required the limited partners to pay management fees to the general partner. Generally, these fees range from 1 to 2 percent of a limited partner's capital commitment and are paid annually for the first 5 years of the partnership when the general partner is identifying acquisition targets. After 5 years the fee is eliminated or reduced to 0.5 to 0.75 percent of invested capital. The sixth fund did not require a management fee, but required the limited partners to pay the fund's expenses up to 2 percent of fund assets and unused capital commitments.

The partnership agreements generally do not permit limited partners to unilaterally withdraw from participation in the fund or an individual acquisition. However, a limited partner may ask for the general partner's approval to withdraw from a particular acquisition if its participation would result in the limited partner violating a law. Generally, the funds also permit a limited partner, with the consent of the general partner, to sell or transfer its interest in the fund to another investor.

Pension Plan Returns on LBO-Fund Investments

The annual rate of return that six of the eight sponsors obtained on their LBO-fund investments greatly exceeded the return obtained on total plan investments. Officials of the eight plan sponsors said they had compounded annual returns on LBO-fund investments ranging from 10.5 to 40 percent. As shown in figure 3, the returns the plans received on total plan investments during the same period ranged from 9.0 to 16.1 percent.

Figure 3: Annual Return on LBO-Fund Investments Compared With Returns on Total Plan Investments



The plan sponsors labeled A through D are the private sponsors we contacted, and plans E through H are the public sponsors.

The public plans we contacted generally realized larger returns on their LBO-fund investments than the private plans, apparently because they have been making this type of investment for a longer period of time. Plan officials told us that the large returns associated with an LBO-fund investment are not realized until the fund's acquisitions are sold, recapitalized, or taken public.

Department of Labor's Enforcement Efforts

To protect pension plan participants, ERISA established fiduciary standards for how plans are to be operated in the interest of participants. ERISA defines a fiduciary as anyone who exercises discretionary control or authority over the management of a plan or renders investment advice to a plan. Generally, these standards require plan fiduciaries to act with care, skill, prudence, and diligence in investing plan assets, and to manage plan assets solely in the interest of plan participants and beneficiaries. ERISA also provides that plan assets be diversified to help minimize the risk of large losses. The provisions, however, allow fiduciaries substantial investment flexibility, because they generally do not specify the degree of diversification required.

ERISA's fiduciary provisions do not apply to pension plans sponsored by state and local governments. While many states have adopted some variation of ERISA's fiduciary provisions, other states have not. The four public plans we contacted were all required to satisfy state fiduciary laws similar to ERISA.

The Department of Labor's Pension and Welfare Benefits Administration (PWBA) is responsible for enforcing ERISA's fiduciary provisions as they apply to private pension plans. According to a PWBA official, pension plan investments in LBO funds are not viewed differently than other pension plan investments. Although a plan's LBO-fund investments may be reviewed as part of a Labor investigation, plans would not be singled out for investigation because they had invested in an LBO fund. However, the official indicated that they would investigate an LBO fund if they received a specific allegation of an ERISA violation by a firm sponsoring an LBO fund.

As of January 1989, PWBA had conducted one investigation concerning an LBO fund. The investigation was initiated based on allegations that the fund's general partner was receiving a disproportionately large share of the profits and large management fees. The investigation was closed in September 1987 without finding any ERISA violations, because PWBA concluded that the fees paid to the general partner, although high, were customary for an active manager engaged in this kind of transaction, and the general partner's earnings did not appear unreasonable considering the services provided and the large returns received by the plans.

Closing Observations

In summary, the eight pension plan sponsors we contacted have invested a relatively small portion of their assets in LBO funds, and most have received higher returns than achieved on other plan investments. Further, the plans appear to be selective in choosing LBO funds in which to invest, and most had diversified their investments among different funds.

Each of the LBO-fund partnership agreements we reviewed had similar provisions concerning their operations, management fees, and allocation of profits and losses between the general partner and limited partners.

We provided officials from the Department of Labor's Pension and Welfare Benefits Administration an opportunity to review a draft of this report; however, they had no comments. We are sending copies of this report to the Department of Labor, the Internal Revenue Service, and other interested parties, and we will make copies available to others on request. The major contributors to this report are listed in appendix I.

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