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PRIVATE EQUITY

Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention

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Highlights

Highlights of GAO-08-885, a report to congressional requesters

Why GAO Did This Study

The increase in leveraged buyouts (LBO) of U.S. companies by private equity funds prior to the slowdown in mid-2007 has raised questions about the potential impact of these deals. Some praise LBOs for creating new governance structures for companies and providing longer term investment opportunities for investors. Others criticize LBOs for causing job losses and burdening companies with too much debt. This report addresses the (1) effect of recent private equity LBOs on acquired companies and employment, (2) impact of LBOs jointly undertaken by two or more private equity funds on competition, (3) Securities and Exchange Commission's (SEC) oversight of private equity funds and their advisers, and (4) regulatory oversight of commercial and investment banks that have financed recent LBOs. GAO reviewed academic research, analyzed recent LBO data, conducted case studies, reviewed regulators' policy documents and examinations, and interviewed regulatory and industry officials, and academics.

What GAO Recommends

GAO recommends that the federal financial regulators give increased attention to ensuring that their oversight of leveraged lending at their regulated institutions takes into consideration systemic risk implications raised by changes in the broader financial markets. In line with the recommendation, the regulators acknowledged the need to factor in such implications into their approach to overseeing their regulated institutions' activities.

To view the full product, including the scope and methodology, click on GAO-08-885. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

Academic research that GAO reviewed generally suggests that recent private equity LBOs have had a positive impact on the financial performance of the acquired companies, but determining whether the impact resulted from the actions taken by the private equity firms versus other factors is difficult. The research also indicates that private equity LBOs are associated with lower employment growth than comparable companies. However, uncertainty remains about the employment effect—in part because, as one study found, target companies had lower employment growth before being acquired. Further research may shed light on the causal relationship between private equity and employment growth, if any.

Private equity firms have increasingly joined together to acquire target companies (called "club deals"). In 2007, there were 28 club deals, totaling about $217 billion in value. Club deals could reduce or increase the number of firms bidding on a target company and, thus, affect competition. In analyzing 325 public-to-private LBOs done from 1998 through 2007, GAO generally found no statistical indication that club deals, in aggregate, were associated with lower or higher prices paid for the target companies, after controlling for differences in the targets. However, our results do not rule out the possibility of parties engaging in illegal behavior in any particular LBO. Indeed, according to securities filings and media reports, some large club deals have led to lawsuits and an inquiry into the practice by the Department of Justice.

Because private equity funds and their advisers typically claim an exemption from registration as an investment company or investment adviser, respectively, SEC exercises limited oversight of these entities. However, in examining some registered advisers to private equity funds, SEC has found some control weaknesses but generally has not found such funds to pose significant concerns for fund investors. The growth in LBOs has led to greater regulatory scrutiny. SEC, along with other regulators, has identified conflicts of interest arising in LBOs as a potential concern and is analyzing the issue.

Before 2007, federal financial regulators generally found that the major institutions that financed LBOs were managing the associated risks. However, after problems with subprime mortgages spilled over to other markets in mid-2007, the institutions were being exposed to greater-than-expected risk. As a result, the regulators reassessed the institutions' risk-management practices and identified some weaknesses. The regulators are monitoring efforts being taken to address weaknesses and considering the need to issue related guidance. While the institutions have taken steps to decrease their risk exposures, the spillover effects from the subprime mortgage problems to leveraged loans illustrate the importance of understanding and monitoring conditions in the broader markets, including connections between them. Failure to do so could limit the effectiveness and ability of regulators to address issues when they occur.