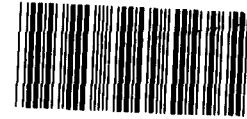


GAO

Testimony



137908

For Release
on Delivery
Expected at
10:00 a.m. EST
Thursday
February 9, 1989

**Pension Plan Participation In
Leveraged Buyout Funds**

Statement of
Joseph F. Delfico, Director of
Income Security Issues
Human Resources Division

Before the
Subcommittee on Labor-Management
Relations
Committee on Education and Labor
House of Representatives



044570/137908

SUMMARY

GAO is reviewing the involvement of pension plans in leveraged buyouts (LBOs) for the Subcommittee on Labor-Management Relations, House Committee on Education and Labor.

Pension plans can participate in LBOs in different ways. They may invest in LBO funds that pool capital for leveraged buyouts, purchase high yield, non-investment grade bonds (commonly called junk bonds) used to finance LBOs, or they may hold shares of stock or bonds in companies that are the targets of an LBO.

The initial phase of GAO's work focused on determining how pension plans evaluate the risks and returns of investing in LBO funds, and identifying the principal provisions of LBO funds. LBO funds are a large source of liquid capital that has played an important role in financing the equity portion of LBOs. These funds, which pool capital provided by large investors, such as pension plans and insurance companies, are formed as limited partnerships by firms that specialize in leveraged buyouts.

GAO interviewed representatives from four of the nation's largest pension plan sponsors. Collectively, these four sponsor 128 defined benefit plans with \$18 billion in assets. GAO also reviewed the limited partnership agreements and related documents for six LBO funds with about \$7.9 billion in committed capital from all investors.

Generally, the LBO fund limited partnerships GAO reviewed were established to identify and acquire suitable businesses through leveraged buyouts, required the limited partners to pay a management fee of from 1 to 2 percent of their capital commitment for the first five years of the partnership when the general partner is identifying acquisition targets, and distribute 80 percent of the profits to the limited partners and 20 percent to the general partner.

The four pension plan sponsors GAO contacted have invested a relatively small portion of their assets in LBO funds, and 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 have diversified their investments among different funds.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the preliminary results of our work on the role of pension funds in leveraged buyouts (LBOs).

Leveraged buyouts can take several different forms. Typically, LBOs involve the acquisition of a public company by a group of investors who purchase the company's stock using mostly borrowed funds with the company's assets as collateral.

Pension plans can participate in LBOs in different ways. They may invest in LBO funds that pool capital for leveraged buyouts, purchase high yield, non-investment grade bonds (commonly called junk bonds) used to finance LBOs, or they may hold shares of stock or bonds in companies that are the targets of an LBO. Your January 6, 1989, letter asked us to address several aspects of this issue.

Our initial work, which is the subject of my statement today, focuses on pension plans' investment in LBO funds. We intend to continue our work in this area including reviewing the participation of public plans in LBO funds and interviewing general partners of several LBO funds.

BACKGROUND

According to a September 1987 report by the Congressional Research Service, LBO transactions have increased dramatically in the past few years, more than tripling from 99 in 1981 to 308 in 1986. The value of these transactions has also risen sharply from a total of \$3.1 billion in 1981 to \$40.9 billion in 1986.

More recently, a report by Salomon Brothers estimated the value of major LBO transactions from 1985 through 1988 at almost \$65 billion, not including the recent purchase of RJR Nabisco by Kohlberg Kravis Roberts & Co. (KKR) for about \$25 billion.

LBOs are typically financed using a combination of debt and equity. In recent testimony, the Secretary of the Treasury stated that senior debt, generally supplied by bank loans secured by the company's assets, is estimated to represent about 55 percent of the financing. Subordinated debt (sometimes called mezzanine financing) is often provided by investment bankers in the form of short-term loans (bridge loans) which are usually replaced by junk bonds. The subordinated debt generally comprises about 30 percent of the LBO's total capitalization. The final 15 percent typically represents equity supplied by an LBO fund.

LBO funds pool capital provided by large investors, such as pension plans and insurance companies. They are formed as limited partnerships by firms, such as KKR and Forstmann Little & Co., that specialize in leveraged buyouts. The firms serve as the general partner for the fund, and the pension plans and other investors are limited partners. One pension plan official told us that there may be as many as 200 firms seeking capital for LBO funds.

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. However, this amount is understated. Our work has identified several other plans that invest in LBO funds that were not identified in this survey.

The initial phase of our work focused on determining how pension plans evaluate the risks and returns of investing in LBO funds, and identifying the principal provisions of LBO funds. To accomplish this, we interviewed representatives from four of the nation's largest pension plan sponsors. Collectively, these four sponsor 128 defined benefit plans with \$18 billion in assets. We also reviewed the limited partnership agreements and related documents for six LBO funds in which one or more of these plan sponsors had invested. The six LBO funds had about \$7.9 billion in committed capital from all investors. We also obtained information on the Department of Labor's oversight of pension investments in LBO funds pursuant to the Employee Retirement Income Security Act of 1974 (ERISA).

PLANS' EVALUATION OF LBO FUND INVESTMENTS

The four plan sponsors we contacted had \$474 million in plan assets invested in 44 LBO funds. As shown in figure 1, their LBO fund investments represented 0.4, 5.7, 1.7 and 1.0 percent of their respective plan assets. All LBO fund investments were made with defined benefit plan assets. Plan officials told us that most of these plans were fully funded or in some cases substantially overfunded.

The four plan sponsors typically begin their evaluation process by reviewing confidential offering memorandums that LBO

firms use to solicit capital commitments for an LBO fund. Generally, the memorandum describes the general partner's experience in the LBO area and the performance of their past LBO investments. It also explains the fund's purpose, 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.

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 has no input concerning the company to be acquired or price of the acquisition. As a result, the plan's evaluation focuses on such factors as the reputation, experience and track record of the general partner as an LBO manager. For example, officials from one plan sponsor said they preferred to invest only with general partners who engaged in friendly acquisitions -- those that are not opposed by the company's board of directors and where existing management would be maintained. The plans have many LBO fund investment offers to choose from. For example, officials from one plan sponsor said they evaluated between 50 and 75 offering memorandums a year before deciding to invest in 15 funds. Another evaluated over 100 memorandums and participated in only 5 funds.

There are several types of risk associated with LBO fund investments. 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 assets to service the large amount of debt issued for the acquisition.

Plan officials told us that there was typically not much negotiation on the terms and conditions of the larger LBO funds. However, three of the four plans said they negotiated some of the management fees and profit distributions for some of the smaller funds or in funds where the plan is the first or biggest investor.

PRINCIPAL PROVISIONS OF LBO FUNDS

All six LBO funds we reviewed were structured as limited partnerships, with the LBO firm acting as the general partner, and the pension plans participating as limited partners. The purpose of the funds was typically to identify and acquire suitable businesses through leveraged buyouts. The funds generally last for 7 to 12 years, with provision for the general partner to extend the fund under certain circumstances.

The partnership documents 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. Four of the six funds limited their investments to friendly takeovers.

Two funds limited the amount of capital that could be used for any acquisition to 10 or 25 percent of total capital commitments. These two funds also indicated that they would use the capital to make between 5 and 20 acquisitions

In all six funds, the general partners contributed one 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 distribute 80 percent of the profits to the limited partners and 20 percent to the general partner. One fund, however, did 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 made their 80/20 distribution only after the limited partners had received a return of their invested capital plus a rate of return of between 12 and 30 percent.

Five of the funds require the limited partners to pay management fees to the general partner. Generally, the fees range from 1 to 2 percent of a limited partner's capital commitment and are paid for the first five years of the partnership when the general partner is identifying acquisition targets. After the five 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.

Partnership documents generally do not permit limited partners to unilaterally withdraw from participation in the fund or in an individual acquisition. One exception would be if a limited partner determines, subject to the approval of the general partner, that a fund acquisition would result in the limited partner violating a law. For example, a pension plan may be able to withdraw from a particular acquisition if it would cause the plan to violate ERISA. Although partnership interests cannot be traded on the open market, generally, the funds permit a limited partner, with the consent of the general partner, to sell or transfer its interest in the fund to another investor.

PLAN RETURNS ON LBO FUND INVESTMENTS

Officials of the four plan sponsors said they had compounded annual returns of 40 percent, 24 percent, 21 percent, and 10.5 percent on their LBO fund investments. The returns the plans received on total plan assets were 11.1, 9.0, 16.1 and 10.8 percent, respectively. These officials told us, however, that the large returns associated with an LBO fund investment are not realized until the fund's acquisitions are sold, recapitalized or taken public. As a result, they expect to see an increase in the returns on their LBO fund investments over the next few years.

Most of the plan officials had not studied the extent to which plan assets, other than their LBO fund investments, had

been affected by LBOs. However, one plan told us they made \$2 million on stock as a result of a recent takeover, and another plan experienced a significant loss in the value of bonds it held.

LABOR'S ENFORCEMENT EFFORTS

ERISA established comprehensive minimum fiduciary standards for how pension plan assets are to be managed solely in the interest of plan participants and beneficiaries. Generally, these standards require plan fiduciaries to act with care, skill, prudence and diligence in investing plan assets. ERISA also generally requires that plan assets be diversified to help minimize the risk of large losses. The provisions allow fiduciaries substantial investment flexibility, because they generally do not specify the degree of diversification required.

The Department of Labor's Pension and Welfare Benefits Administration (PWBA) is responsible for enforcing ERISA's fiduciary provisions. PWBA officials told us that to determine whether the general partners of an LBO fund are plan fiduciaries it would be necessary to determine whether the funds involved are plan assets. PWBA officials told us they were not aware of any rulings by Labor on whether pension plan investments in an LBO fund are considered plan assets.

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 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.

According to a PWBA official, LBO funds have not been targeted for investigation. 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 the LBO fund.

CLOSING OBSERVATIONS

In summary, the four pension plan sponsors we contacted have invested a relatively small portion of their assets in LBO funds, and 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 have made an effort to diversify 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 intend to continue our work in this area including reviewing the participation of public plans in LBO funds and interviewing general partners of several LBO funds. We look

forward to exploring with you and your staff other aspects of the role of pensions plans in LBOs that warrant our attention.

- - - -

Mr. Chairman, this completes my statement. I would be happy to answer any questions at this time.

Figure 1: Percentage of Plan Assets Invested in LBO Funds

