THE SUNDAY TIMES

Buffett joins barbarians at the gate

After four takeovers worth a total of almost $100bn, are megadeals back?

Simon Duke and Ben Marlow Published: 17 February 2013

Warren Buffett linked up with Brazil's 3G Capital to launch a $28bn takeover of Heinz (Scott Eells)

After months of slumber, the fiercest hunter in the corporate jungle emerged from his lair. And after a $28bn feast of Heinz baked beans, Warren Buffett declared he was hungry for even bigger prey. "I am ready for another elephant, so if you see one walking by just tell me," joked the world's third-richest man, whose Berkshire Hathaway empire holds chunks of Tesco, Coca-Cola and Kraft Foods.

With help from 3G Capital, a Brazilian investment firm, Buffett will take private one of the world's best-known consumer companies, founded in 1869.

The swoop on Heinz is the latest in a slew of gigantic takeovers that has fuelled hopes of a return to the swashbuckling days of deal making. However, some of the acquisitions have required huge loans — an uncomfortable reminder of the credit boom before the crash.

"Confidence is coming back. The private equity market hasn't felt this positive since before the crisis," said Fotis Hasiotis, a senior private equity specialist at Lazard.

In the past fortnight four megadeals worth a total of nearly $100bn (£65bn) have been unveiled.

The tech tycoon Michael Dell kicked off the bonanza with a $25bn buyback of the computer manufacturer he founded. It was the biggest takeover announcement since the private equity giant Blackstone swooped on Hilton Hotels in 2007. The same day, the media mogul John Malone shelled out $23bn to buy Virgin Media.

A week later Comcast, the US cable provider, announced an $18bn buyout of NBC Universal, the television and film company. The spree was capped off by Buffett's $28bn swoop on Heinz last Thursday.

Green shoots of recovery, a lull in the eurozone crisis and vibrant financial markets have coaxed buyers out of their shells. "Sentiment is changing. For the past four years boardrooms have been wary of doing deals," said Richard Sheppard, head of UK mergers and acquisitions at Deutsche Bank.

"Now it looks like the problems in the eurozone are stabilising, the mood is improving. With strong stock markets and readily available financing, there is potentially perfect conditions for deals."

Some observers fear, however, that a bubble is emerging which could create the foundation of a new and more devastating financial catastrophe.

There may be a dearth of affordable loans for small businesses but, by some measures, credit is as cheap as it has ever been for large companies. With interest rates in America and Britain unlikely to rise substantially for years, pension funds and insurers have been forced to switch from government bonds to higher-yielding but riskier assets.

As a result, cash is flooding into corporate loans. This has been most pronounced in the so-called junk bond market. Borrowing costs for corporations not secure enough to obtain an investment-grade credit rating have halved since 2009, tumbling to a recent all-time low of 6%.

At the same time, buyout firms are on the comeback trail after sustaining heavy losses on investments made at the height of the credit boom in 2006 and 2007. In total, private equity firms have about $100bn to spend on acquisitions this year. Under agreements struck with investors, the buyout firms will have to hand back the money if they don't use it.

In short, all the ingredients are in place for another takeover bonanza. "There is no doubt that there's a bubble in the bond markets. The real question is how long it will last," one senior banker said. "There could be a minimal time frame for private equity firms to get deals done. This is why banks are queuing up to offer loans."

Of course, at some point the debt will have to be repaid, or more likely rolled over. If the bubble bursts in the debt market, businesses may struggle to refinance their borrowings.

This is what sealed the fate of EMI, the music giant bought by Guy Hands for £4bn in 2007. It fell into the hands of Citibank after he failed to meet the terms of its loans.

Scores of other companies taken over during the boom ended up in the hands of the lenders. Many survive as corporate "zombies", whose suffocating debts leave them with no way to invest for the future.

The proposed buyout of Dell will need $12bn of loans. That is a heavy burden for a company whose mainstay PC business has been hit hard by tablets and smartphones. Heinz's debt mountain will also increase after its takeover by Buffett.

Virgin Media will present even more of a test. Its new owner, Malone's Liberty Global, plans to pile £5bn of debt onto the British firm. About half will come from the high-yield bond market. The plan will rely on Liberty securing low rates. This risky strategy will only pay off if Virgin Media's cash flow continues to climb.

Worryingly, about 29% of bonds issued by American companies are "covenant-lite", offering little protection for creditors if the borrower gets into trouble. That compares with 18% in the run-up to the 2008 financial crisis. (Conventional loans, by contrast, allow creditors to declare a default if the borrower does not hit its earnings or cashflow targets within specified margins.)

The boom in the debt market is causing deep concern at America's central bank. Jeremy Stein, one of the Federal Reserve governors, recently warned that junk bond prices may be overheating.

"It does not bode well for expected returns to junk bond and leveraged-loan investors," said Stein. Or, he might have said, the fragile banks that are shovelling out the cash.

Such warnings have fallen on deaf ears in the City, where some bankers are hoping for a fees bonanza. The mistakes of EMI and other disasters have been learnt and caution prevails, they argue. "You won't see [private equity] firms chasing companies in structurally challenged industries," one source said.

Others aren't so sure. Buyout firms simply won't be able to resist the cheap cash available in the bond market, said another. "They will still look to pile as much cheap debt as possible onto the companies they are buying. That's how you maximise your returns."

However bullish dealmakers may be feeling, a £10bn takeover is about the limit in Britain today.

So which companies are potential targets? Top of the list is EE, the telecoms giant that owns T-Mobile and Orange. Preparations for a float this year have alerted big private equity players.

Another candidate is Urenco, the nuclear fuel maker earmarked for privatisation. It has interest from four of Europe's biggest private equity houses.

Speculation is also swirling round Marks & Spencer, ITV and Sage, the FTSE 100 software company. All were mooted as takeover targets during the last period of easy money.

The sage who loves brands

Famed as much for his homespun aphorisms as his investment prowess, Warren Buffett has made a fortune from swooping on all-American names.

From stakes in Coca-Cola to the processed cheese maker Kraft, Buffett has amassed a $46bn fortune by betting on brands that resonate strongly with consumers and have rock-solid cash flows. Heinz, the canned beans and ketchup giant, certainly fits that bill.

But he is paying a high price for this peace of mind. At $28bn, the deal values Heinz at 20 times its projected earnings for this year. Few investors in his Berkshire Hathaway investment group are likely to quibble. As the sage himself once said: “It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.”