The party goes on

JULIA BERRIS FINDS OUT WHY THERE IS SUCH AN APPETITE FOR LEVERAGED BUY-OUT DEALS.

Leveraged lending continues apace. According to Standard & Poor's Leveraged Commentary & Data (LCD) volume in US and Europe has increased from a low in 2002 of €180bn to €500bn in 2006. And with the appetite seeming to grow on what it feeds, 2007 could be a bumper year.

The Financial Services Authority (FSA) is taking a close interest in leverage finance. It notes that banks have been offering higher leverage on bigger deals with weaker loan covenants. Last year, the FSA noted a rapid increase in leverage lending, much of it associated with an equally rapid growth in the private equity market and that trend is continuing. The FSA says there has been a significant increase in both the size of the deals and in the amount of leverage within their financing structures.

HISTORIC HIGHS As the average deal size has grown, so banks' exposure to leveraged buy-outs (LBOs) has become more concentrated, with firms' top five deals representing on average 47% of their exposure. The average leverage on the five largest transactions, measured by the debt/EBITDA ratio was 6.41. The FSA says this is a historically high figure, and also well above the leverage seen on smaller transactions.

Firms attempt to limit their exposure by distributing the debt they underwrite. On average, banks were only holding 20% of the original debt for their top five transactions 120 days after the completion.

The 80% was sold to a range of buyers which included institutional investors, hedge funds and firms specialising in the structuring of debt instruments such as collateralised loan obligations. However, the FSA warns that: "A shift in market sentiment could result in banks being obliged to sell on debt at a loss or even being unable to find buyers."

The increase in leverage has been driven in part by the rise in asset prices. However it also reflects the high degree of liquidity and increased willingness to hold riskier assets.

The private equity and leveraged loan markets, according to the FSA, show clear evidence of capital chasing assets, as the prices of deals are bid up through competition from rival private equity groups and their financing banks. There are risks out there: there is evidence of erosion of loan covenants, with less robust triggers that reduce not only protection for lenders but also the extent to which loan covenants can give early warnings of corporate distress.

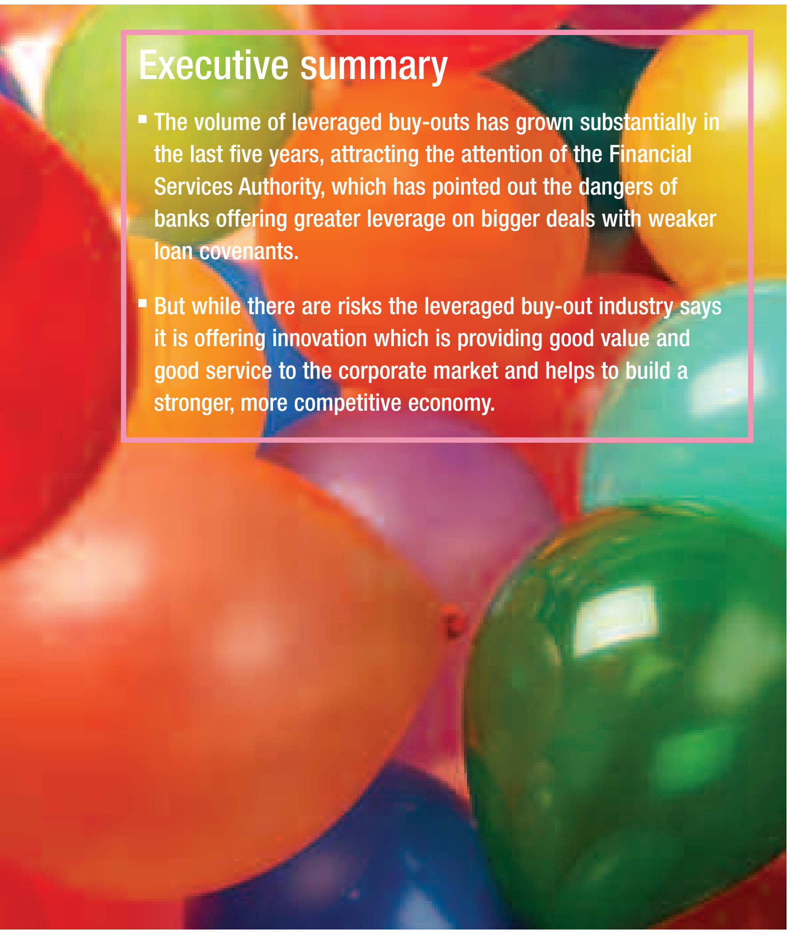
THE PARTY GOES ON But for now the party goes on. This looks set to be a busy year for the multitude of private equity houses. With a (seemingly aborted) bidding war for Sainsbury's kicking off in March and Birds Eye closing factories after its takeover by private equity, the industry is under the spotlight. Such LBOs – taking such well-known and large public companies private with such large amounts of debt capital – would have been unimaginable a couple of years ago.

Alison Rose, Managing Director and Head of Leveraged Finance UK at RBS, says: "As these private equity firms bid for larger public companies, we have seen a lot more press coverage, particularly over the last six months. They have come into the consciousness of the mainstream press whereas before they haven't attracted as much attention or focus."

The size of funds has increased and has thrust private equity into a new realm of investment opportunities in Europe with significantly larger targets. As fundraising has increased, larger transactions have become accessible to the private equity players and transactions with a multibillion price tag in the public arena are viable targets.

INNOVATIVE LENDING Rose says: "At the same time there has been considerable development in both the public and private debt markets facilitating greater liquidity to finance these transactions." Leveraged finance has become increasingly innovative in structuring debt solutions with access to a broader range of debt products and distribution channels, and structures today typically include various tranches of debt across both the senior and subordinated markets. As the market booms, treasurers need to be aware of the challenges they may face if their corporate becomes a private equity target.

Treasurers working for a corporate or a division which is the target



Executive summary

- The volume of leveraged buy-outs has grown substantially in the last five years, attracting the attention of the Financial Services Authority, which has pointed out the dangers of banks offering greater leverage on bigger deals with weaker loan covenants.
- But while there are risks the leveraged buy-out industry says it is offering innovation which is providing good value and good service to the corporate market and helps to build a stronger, more competitive economy.

of an LBO will find the nature of their job changes. Group Treasurer at Linpac is Andrew Foulkes. Linpac has a turnover of about £1.2bn and was bought by Montague Private Equity, the spin-off from HSBC. Foulkes says: "If a family owned company with little debt suddenly moves into a highly leveraged structure, the dynamic changes. The company may have had little need for centralised treasury, relying instead on financial controllers to manage basic treasury tasks. Now, out on their own and in the spotlight of banks and investors, they have no infrastructure and are suddenly in a completely new and demanding world, so they need quickly to develop a more sophisticated structure."

The new company will probably move from having no debt or some inter-company loans to a mountain of syndicated debt, bringing with it constraints that will immediately change the way the treasury team will work. For example, restrictions on which banks may be used on a regular basis can be an immediate issue for treasurers.

A CHANGING CULTURE Foulkes says: "There will be many restrictions and limits. For example, it may no longer be permissible to keep surplus cash in accounts with a bank that is not part of the main lending syndicate. Or you may not be able to retain local overdrafts for your overseas subsidiaries because their banks are not part of the syndicate."

Foulkes recommends treasurers make sure they are fully involved if their company becomes the target of such interest.

Keeping in line with new rules and binding regulations is a must. Treasurers must be sure they know exactly what the implications are.

Foulkes says: "The best preparation is to make sure, as quickly as possible, that the treasury team can participate in the negotiation of the loan agreement and can spot any limits and restrictions that are too onerous and can stop the business working in the normal commercial way."

Once the deal is done, educating the new company's management team in what can and cannot be done is very important. Staff must fully understand how things have changed and that their behaviour must be adapted to the new regulations that cannot be breached.

Press coverage has certainly focused on the negative aspects of the private equity industry. The business pages often feature horror stories of factories in sleepy UK towns being closed and firms behaving without business ethics.

THE POSITIVE IMPACT Is it really this bad? Perhaps unsurprisingly Rose argues that the press overlooks the positive impact private equity has had on the British economy. Rose says: "The private equity industry recognises that it has attracted a lot of attention and has been asked to explain more about how they work. There is a huge amount of misunderstanding and because it is private rather than public there is a lot of suspicion about how it works."

Rose says that the private equity industry has not dedicated its time to a public relations exercise which would help to highlight some of the positive things the industry has done for the economy.

She says: "There are many examples of where investment from private equity has created very successful businesses with a motivated management team and staff and have added value through supporting growth and investment which previously may not have been possible and created returns for everyone."

The private equity industry has been criticised for a lack of transparency by government, pressure groups and trade unions in the UK. Many have called for tighter regulation from the Financial Services Authority to enforce a more transparent method of working and disclosure of information.

Rose argues that private equity houses are not as secretive as we are led to believe.

She says: "They share a lot of information with their investors and lenders and in most instances disclose a lot more than many public companies provide to their shareholders. I find it very interesting that they are labelled as not being transparent."

Rose says investors are given details about where the money is going, how the business is performing and future developments and how the asset is performing.

Rose says: "There is nothing to suggest the leveraged finance industry will change and the outlook for 2007 is positive."

An assessment that the FSA would agree with. Lending has been supported by strong earnings performance from the non-financial sector and favourable economic conditions. Corporate failures remain near historic lows. However, the FSA points out that the financial health of companies that are highly leveraged tends to rely heavily on the strength of the economy and the level of interest rates. With the global economy expected to slow some companies could find themselves under pressure.

Julia Berris is a Reporter on *The Treasurer*.
editor@treasurers.org

Alison Rose and Andrew Foulkes are part of a themed panel session at The Treasurer's Conference, along with Chris Kelly, Director PPM, looking at the opportunities in the leveraged finance arena and developments in private equity investment. See page 28 for a conference preview.