Bricks in the wall

REFINANCING LEVERAGED BUY-OUT LOANS OVER THE NEXT FOUR YEARS WILL PROVE A CHALLENGE FOR MANY EUROPEAN COMPANIES AND MAY BE IMPOSSIBLE FOR SOME, A NEW REPORT WARNS. **GRAHAM BUCK** REPORTS.

European companies face a rocky ride over the next four years, a legacy of the leveraged buy-out (LBO) boom that ran from 2004 until 2008 according to a new report.

The report, "Off piste: Negotiating Europe's LBO Debt Mountain", was produced by law firm Linklaters and is based on data produced by Dealogic. It outlines how almost $550bn of European LBO loans are due to mature between 2012 and 2016. Annual totals commence with $69bn of refinancings due this year, rising to peaks of $140bn in 2014 and $135bn in 2015, before easing back to $103bn in 2016.

By far the biggest chunk of this total relates to the UK, where $172bn in refinancings fall due over the four-year period, followed by France ($86bn), Germany ($83bn), the Netherlands ($36bn), Italy ($31bn), Denmark ($30bn) and Spain ($25bn). By contrast, figures for the stricken economies of Ireland, Greece and Portugal are negligible.

Broken down by industry sector, the five main LBO refinancing hot spots are telecoms ($67bn), retail ($47bn), healthcare ($40bn), chemicals ($37bn) and construction/building ($36bn).

PEAK REFINANCING In the UK, this year marks the peak for refinancing LBO loans in the utility and energy sectors and 2013 is crunch year for transportation, chemicals, healthcare and insurance. The largest overall LBO loan requirement over the 2012–16 period is for the retail sector.

As the report notes, refinancing this "wall of debt" was progressing well until quite recently. Refinancing activity started to recover in 2010 from the credit drought that followed the collapse of Lehman Brothers two years earlier, then rose strongly over the first three quarters of 2011. However, the deepening euro zone crisis then intervened, choking off activity in the fourth quarter when successful European LBO refinancings slumped back to the low levels of 2009.

Research also suggests that the debt wall is moving, as many European LBO refinancings completed in 2009–11 typically had tenors of between three to five years, compared with seven to 10 years for those in the 2004–08 boom period. This has effectively created two separate shoals of refinancing that both fall due between now and 2016.

With the outcome of the euro zone crisis still unclear, a lack of confidence – both politically and economically – is persisting. These conditions affect European LBO loans generally, with countries perceived as particularly vulnerable hit hardest.

More demanding regulatory requirements on banks to deleverage their balance sheets and raise more capital make them less likely to participate in refinancings over the next few years. Collateralised loan obligation (CLO) funds, collectively another key investor group in the boom years, are also regarded as unlikely to participate to the same extent in future as their constitutions limit the extent to which they may invest or reinvest. Ratings agency Standard & Poor's expects most European CLOs to fall away from the debt finance market just as the wall of debt peaks.

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The situation may be made more acute if those entities still involved in refinancings approach them "with a different mindset and objectives". Such a change could result from the "seismic" shifts taking place in financial markets and/or increased government intervention in the restructuring process – either through their shareholdings in banks or the introduction of legislative or regulatory changes.

The report authors add that these problems take place against a difficult economic backdrop. They cite the IMF's growth forecasts for the euro zone and individual European countries, which were downgraded again early this year and the S&P European Leveraged Loan Index, which rose sharply in the latter half of 2011 to reach 4.1% in December – more than double the year-end level of 2% in 2010.

DEBT RESTRUCTURING GOES ON THE FRONT-BURNER All of these developments are seen as bringing forward the date on which a company's debt structure will need to be addressed. The increase in defaults has been accompanied by more restructurings involving some sort of debt write-down or conversion into equity, as stakeholders acknowledge that covenant breaches may reflect more fundamental problems with the company's debt and capital structure. Companies with high debt burdens in more vulnerable countries and/or sectors are more likely to explore this route.

The report is not unremittingly negative. Banks are also under pressure to lend more, which they must balance against regulatory requirements, and may respond by giving greater priority to companies in their home market. CLO funds can continue to make new investments in LBO loans until the end of their investment periods – typically

between now and 2014 but later for some newer vehicles structured just before the credit crunch. They may also be able to restructure existing investments in order to maintain their participation in those loans.

There are also alternative sources of finance that "may be available to the right borrower on the right terms". The report suggests that the European high-yield bond market looks set to play an increasing role, while the US high-yield bond market may also move in by offering US dollar funding to more European issuers.

While the arrival of the European high-yield market has been long forecast, it now looks set to become a reality thanks to the strong fundamentals of extended monetary policy, low interest rate expectations, high investor cash balances and the search for yield. Companies with major US operations or in a sector that US investors understand and follow are even better positioned as they can more easily access "the still more stable and liquid US market".

Alternative capital providers, ranging from insurance companies and pension funds to hedge funds and credit funds are potentially a further source of LBO refinancing, and could be joined by sovereign wealth funds and private equity. While none of these groups can provide the whole answer, "each can contribute to the solution", say the report authors.

Private equity firms are particularly well positioned to tackle the debt wall, given they have an estimated $937bn of unspent capital at their disposal. Out of this so-called "dry powder" more than one fifth is in funds that must be invested within two years or returned to backers. Around 41% is held by LBO funds and those raised in 2008 alone are said to have about $91.5bn in unspent commitments.

The report points out that in previous recessions private equity focused on corporates and industrials seeking to offload their loss-making, non-core businesses. This time around their equivalent is likely to be financial institutions seeking to shrink their balance sheet and dispose of non-core assets. A recent example was private equity group Bridgepoint Capital's €200m acquisition of Quilter, the private wealth management business of Morgan Stanley.

Not surprisingly the report predicts that companies able to demonstrate a good performance, but concerned by possible disruptions in the market and the future availability of funding, may position themselves at the front of the refinancing queue by entering into a forward start.

These companies regard market illiquidity as an opportunity. In the period that followed Lehman's demise, many found the relatively depressed prices at which their debt then traded becoming disproportionate to the fundamental strength of their business. So they responded by buying back their debt at a discount, strengthening their balance sheet and reducing their overall debt level.

SHORT-TERM FIXES This, however, still leaves the likelihood that less robust companies with LBO loans will not be able to refinance. At the start of the financial crisis many lenders agreed temporary fixes such as covenant waivers and relaxations of interest and amortisation payments. This was in the hope that market conditions would improve and enable the borrower to trade out of its problems.

This scenario is increasingly seen as unlikely. So debt restructuring solutions may become more common, such as debt to equity conversions. The current environment might prompt more lenders to exit by selling their debt into the secondary market at a realistic price, while those remaining negotiate for a more fundamental restructure of the debt and capital structure than might previously have been acceptable. Portfolio sales could increase as a result.

The "last resort" of insolvency could also increase in certain sectors or countries – although it is still likely to be regarded as value-destructive except when employed as a tool to implement an agreed restructuring.

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Corporate bond issues revive

Global corporate bond issues boomed in the first two months of 2012, with the nearly $300bn attracted in February pushing the total for the year to date to $543bn, reports Standard & Poor's.

The agency says that market volatility has eased since late last year, helped by better US economic figures and more positive news on Europe's sovereign debt crisis, which have in turn spurred demand for corporate debt. Both investment-grade and high-yield borrowers are eager to benefit from this sudden liquidity flow, it adds.

Almost two-thirds of the February total consisted of issues by investment-grade firms, 15% from speculative-grade entities and 20% from unrated entities. European companies have accounted for 44% of new issues since the start of 2012, US companies for 32%,