RIDING THE STORM

DESPITE A YEAR OF VOLATILITY AND THE FINANCIAL BACKLASH OF 11 SEPTEMBER THIS YEAR HAS SEEN SOME OF THE BIGGEST EVER LBOS, SAYS **TESSA WALSH** OF LOAN PRICING CORPORATION.

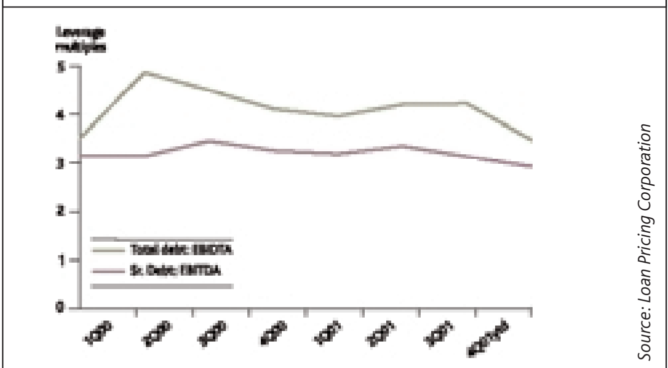
Volatility took the leveraged loan market on a wild ride in 2001, sending deal sizes rocketing, against a background of economic malaise and external shocks. With volume of $91.7bn to November 2001, the leveraged loan market is already 34% ahead of last year, largely due to a succession of huge leveraged buy out (LBO) financings which dominated the market. The European LBO market, which has been the wider Euroloan market's only area of growth in 2001, continued upwards, and the average deal size more than doubled from $250m to $550m.

The **E**1.535bn senior debt financing backing the LBO of German industrial gasses business Messer Griesheim, the £1.05bn LBO financing for Yell, BT's yellow pages unit, and the **E**1.755bn LBO for Dutch packaging company Kappa Packaging, each inherited the title of Europe's largest LBO in quick succession. These lucrative deals, the biggest buy outs since the late 1990s, stemmed from private equity sponsors' realisation that larger businesses are easier to exit, and they joined forces to buy the larger firms being spun off from Europe's corporate disposal programme. The huge LBOs were snapped up by banks and institutions, which quickly appreciated that the deals' large fees and interest margins would help them to meet or exceed budget targets months in advance.

Although LBOs undoubtedly stole the limelight in 2001, the leveraged corporate market, which has long been the preserve of structured telecoms and cable financings, also produced some chunky transactions. The **E**6.14bn loan backing the Fiat and EdF's Italenergia consortium's takeover of Montedison took the title of largest structured financing of the year, and Italian mobile operator Wind completed a **E**5.5bn refinancing.

BEST OF TIMES, WORST OF TIMES. The leveraged market was already starting to catch a cold before 11 September. Poor trading figures and banks' aversion to the telecoms sector after bingeing on telecoms M&A deals in 2000, had left leveraged corporate and LBO loans parked in the market during the summer months as banks shunned risk. The third quarter marked the best and worst of times for the LBO-heavy leveraged market. LBO volumes hit a record high $12.9bn, contributing 65% of leveraged volume of $19.9bn, but the entire leveraged sector suffered a flight to investment-grade quality

FIGURE 1
AVERAGE LBO DEBT: EBITDA.



Source: Loan Pricing Corporation

post-11 September as political and economic uncertainty spiralled. The leveraged market ground to a halt for two months following 11 September, with deals totalling **E**13.2bn in the market and in the pipeline, according to LPC. Many deals have been restructured using market flex to adjust terms and conditions, however, some are still on the balance sheets of arrangers unfortunate enough to be left without this protection.

The leveraged corporate market was boosted by an unusual influx of new blood during the two months of dislocation following 11 September as Europe's first fallen angels entered the market. UK telecoms equipment supplier Marconi's rating plunged to junk, and Dutch telcom KPN, while still technically investment grade, wound up paying 200bp over Libor on its emergency **E**2.5bn loan, which put it in crossover leveraged territory. These swift declines in credit quality have been characteristic of one of the European leveraged market's most lively years of credit events as default rates marched higher amid economic gloom. Banks' worst-case scenario – losing money – was realised on several leveraged deals as alternative telecoms succumbed to bankruptcy, and the LBO of Austria's Steiner Industries collapsed amid allegations of fraud. Lenders also started to grapple with problems surfacing in their portfolios. Arranging banks estimate that up to 30% of some lenders' portfolios are experiencing

time-consuming credit problems, which is a key contributing factor to banks' reluctance to underwrite new credits.

This world of uncertainty opened up a gulf in price expectations between sellers and venture capital buyers and a few high-profile LBOs failed amid purchase price renegotiations, such as the sale of Mannesmann's Plastics Machinery business.

CORRECTION BOOSTS CONFIDENCE. These factors combined to take the wind out of the leveraged market's sails. Confidence rallied in November as a correction followed the market's two-month dislocation, but volume has been hit by this period of reflection, and LBO volume of $8.13bn for the fourth quarter is well off the third quarter figure of $12.9bn. Arrangers' new-found caution is pleasing investors who are quick to appreciate that the best of deals are done in the worst of times, and bank and institutional investors believe that the market is a better place since its correction.

Leveraged specialists concerned about overheating had been nervous that businesses unsuitable for leverage were being loaded with debt prior to 11 September and welcome the flow of stable businesses with solid cashflows, which counter market concern.

Activity returned to the market at the beginning of November and the gap between buyers and sellers began to close, as sellers started to accept purchase price reductions. Unlike sellers, venture capital buyers are facing less competition and now have the luxury of time on their side. The completion of the **E**2.5bn sale of Henkel's speciality chemicals business, Cognis, was eased by an unusual opt-out period between Henkel and sponsors Schroder Ventures and Goldman Sachs Private Equity, which allowed time for renegotiation. The sale was saved by a **E**350m loan from vendor Henkel, which limited the headline purchase price reduction to **E**100m from the original figure of **E**2.6bn and reduced the amount of equity the sponsors had to put in to **E**450m. Cognis' **E**1.6bn LBO financing sports the full range of post-11 September issues and is symptomatic of the more conservative fourth quarter market. The all-senior deal's debt to Ebitda ratios at 3.1 times are among the lowest seen on a large buy out and its 41% equity ratio is high.

Leverage multiples have dropped noticeably in recent months. This is capping purchase prices but has not cut off deal flow, as equity prices have also fallen. Despite fears to the contrary, the high-yield bond market's disappointing performance has also had little impact on deal flow, as mezzanine lenders have stepped into the breach. Although purchase multiples are situation-specific, and average multiples are difficult to define, the market continues to make sharper multiple distinctions between strong and weak credits. Good businesses are still being sold at seven to nine times Ebitda, and less good ones at five times, say bankers.

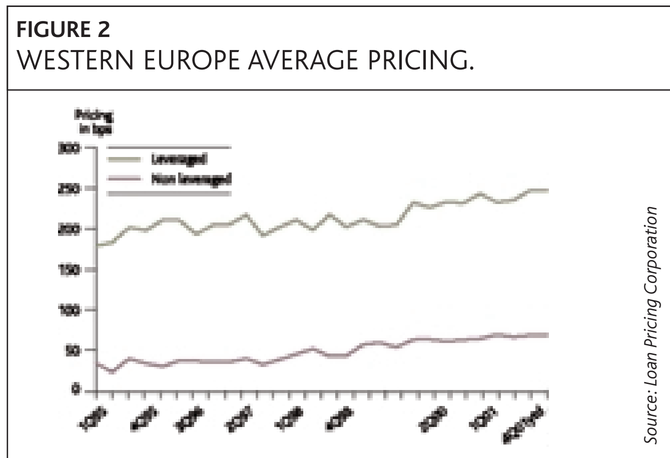


FIGURE 2
WESTERN EUROPE AVERAGE PRICING.

On the financing side, as *Figure 1* shows, levels of senior debt, which are hovering at 3-3.5 times Ebitda have proved more stable than total debt levels, which have dropped considerably.

Although debt multiples are highly dependent on the business under consideration, last year total debt multiples of 5.5-6 times were not uncommon, however 4.5 times is now viewed as the maximum for an exceptionally good business. But, despite the choppy conditions, the market is prepared to make exceptions for strong businesses. The Nkr5.5bn senior debt financing for Norwegian yellow pages business Telenor Media Group has total debt to Ebitda of 6.3 times, and has been well-received by the market.

PRICING HEADING NORTH. As *Figure 2* shows, pricing has been edging up in all areas of the leveraged market. LBO interest margins, particularly on the longer-dated B and C tranches, which institutional investors are fond of, have ticked up by about 50bp to up to 350bp to meet their investment requirements. Arrangers estimate that European institutions alone can contribute up to **E**400m to a deal. Some institutions are getting approvals for ticket sizes of up to **E**50m, which is a significant contribution to liquidity. But leveraged lenders are fickle and are typically more concerned with credit than pricing, as increased pricing is often seen as flagging a problem.

Leveraged telecoms credits have had a proportionately greater increase in pricing than LBOs, but their arrangers have found that upping margins does not always have the desired effect on bank demand. Italian mobile operator Wind paid 175bp, nearly double its last spread of 90bp, on its **E**5.5bn loan. However, the deal encountered a sceptical market and a slow syndication spanned the summer months.

Hybrid corporate/leveraged loans such as the **E**2.4bn loan for the Valentia consortium, which backed its purchase of Eircom's fixed line telecoms operations, failed to find demand despite pricing of 175-275bp over Libor and an investment-grade rating. The arrangers of the loan were left overexposed at the end of the first round of syndication. They were forced to abandon underwriting in favour of smaller, more clearly defined take and hold positions after the market voted with its feet. Further syndication will take place in the New Year, which will reduce arrangers' exposure levels.

WELL POSITIONED FOR 2002. In a further sign of conservatism and credit contraction, the leveraged loan market is less inclined to support growth stories than its high-yield bond counterpart, say bankers. But despite its new-found cynicism, the leveraged market is set to finish the year on a record high with year to date volume of $32.1bn.

Bankers have begun to factor an upturn into projections for the third and fourth quarters of 2002, or – if pessimistic – early 2003, and are broadly positive about next year. "The market's in good shape. This year everyone made good money on the big deals, and all banks have made or beaten existing budget targets. Although next year will be a tougher market in some senses, as there are not so many auctions in the pipeline, underwriting is busy and there's an overhang of deals ready to be launched," says Tim Taylor, Director of Loan Syndications at Deutsche Bank.

Tessa Walsh is Vice President of Loan Pricing Corporation.
tessa.walsh@reuters.com
www.loanpricing.com