Clouds gather over LBOs

PAUL WATTERS EXPLAINS HOW THE DEFAULT RISK IN THE EUROPEAN LEVERAGED BUY-OUT MARKET HAS RISEN SUBSTANTIALLY FROM A DEBT PROVIDER'S PERSPECTIVE. MANY LBOS NOW HAVE LITTLE FINANCIAL FLEXIBILITY TO ACCOMMODATE ANY SHOCKS.

Over the last two years the European leveraged finance market has exploded onto the front pages of the financial press as private equity sponsors dominate the merger and acquisition landscape as well as trade out of their existing portfolio companies. The debt funding required by these private equity-controlled or leveraged buy-outs (LBOs) has created assets to enable banks, and increasingly non-bank institutional investors, to diversify their debt portfolios into higher-yielding assets.

Private equity ownership is no longer a cottage industry. The British Venture Capital Association recently reported that about 2.9 million workers in the UK were employed by private equity-owned firms, representing 19% of the private sector workforce. The firepower available to private equity sponsors also continues to increase with CVC and KKR, for instance, closing dedicated European funds for €6bn in August 2005 and €4.5bn in late 2005 respectively. As a result of this surge in dedicated equity capital and the willingness of lenders to fund these leveraged companies, the size of many buy-outs has grown enormously.

Executive summary

- The willingness of lenders to fund leveraged companies has resulted in a tremendous growth in the size of buy-outs, and this is increasing risk for debt providers.
- The deterioration in credit quality seen in Europe presents a growing risk to lenders.
- The main recent change to capital structure has been an increase in subordinated debt.
- Private equity-driven leveraged finance deals have implications for treasurers over the availability of debt and the threat to the independence of even the largest public companies.

CAPITAL STRUCTURES TEST THE BOUNDARIES It is notable that in 2003 only 2% of the 91 leveraged buy-out deals undertaken in Europe, according to Standard & Poor's Leveraged Commentary and Data, involved debt greater than €1bn, compared with 15% of the 192 completed in 2005. And in Q1 2006, two deals successively broke the record €7.2bn European leveraged buy-out debt package arranged for Wind in July 2005: Ineos (€9.9bn January 2006) and TDC (€12.2bn maximum March 2006).

Not only have cash-rich private equity funds been hunting for larger targets, but the competitive auction process (for new as well as existing sponsor-owned companies) has inflated acquisition prices significantly. Average acquisition multiples closed out 2005 at 8.3 times EBITDA (earnings before interest, tax, depreciation and amortisation) – a new cyclical high – up from 7.7 times in 2004 and the cyclical low of 6.8 times in 2003. For larger transactions, where

EBITDA was more than €500m, the increase was even more marked, with acquisition multiples on average rising from 7.7 times in 2004 to 8.8 times in 2005.

This raises the question of what the capital structure looks like for the average leveraged buy-out and how has it changed in light of the developing market conditions. As *Figure 1* illustrates, the typical capital structure broadly breaks down into 50% senior secured debt, 34% equity (evenly split between ordinary equity and vendor loans), with various forms of subordinated debt comprising the balance.

Looking back over the last couple of years, the main changes to the structure have seen equity contributions fall from 38%-39% in 2002/03, with the slack being absorbed by subordinated debt that provided 10%-12% of total funds in 2002/03.

Second-lien loans have become a common feature of European leveraged buy-outs over the last two years. They are structured to rank *pari passu*, and share the same security package with the senior debt but pay a higher return (Libor+500bp-600bp where there is a mezzanine tranche below). This is to compensate second-lien lenders for contractually waiving their enforcement rights in favour of the first-lien lenders.

The average mezzanine loan supporting leveraged buy-outs in 2005 was €93m and paid a Libor+447bp cash coupon plus a Libor+517bp payment-in-kind coupon. However, the mezzanine loan market for jumbo deals has grown rapidly to the point that transactions such as the £460m arranged for Gala's acquisition of Coral Eurobet in November 2005 are quite feasible. Indeed, as *Figure 1* highlights, private equity sponsors have a clear preference for mezzanine compared with traditional high-yield bonds despite their relatively high cost.

Generally, sponsors no longer have to provide equity warrants (only 18% of mezzanine loans supporting leveraged buy-outs included equity warrants in 2005), but other reasons include the inherent flexibility and private nature of the mezzanine product as well as the relatively low prepayment penalties limited to the first two years.

High-yield bonds are most often used either by non-sponsored leveraged corporates looking to lock in fixed-rate funding from non-bank investors or for very large leveraged buy-outs where the corporate credit rating is B+ or better.

NEGATIVE TREND IN CREDIT QUALITY QUITE CLEAR Standard & Poor's has seen a marked deterioration in credit quality for leveraged buy-outs over the last three years and not just because of increasingly high leverage. While performance issues against Standard & Poor's expectations have undoubtedly weighed on leveraged buy-out corporate credit ratings in the last year or so, more cyclical industries that typically sit outside the leveraged buy-out paradigm, such as the retail and chemical sectors, have become more acceptable candidates – they provided 25% and 20% of leveraged buy-out loan volume in 2004 and 2005 respectively.

In fact, the leveraged buy-out has become a B+/B market from an issuer rating perspective. Only an eighth of the 130 leveraged buy-outs reviewed by Standard and Poor's in 2005 qualified as BB/BB-. And given the rapid pace of loan prepayments, running at almost 10% of investors' portfolios on a quarterly basis during 2005, the declining credit quality of new deals has quickly fed through to investor portfolios.

RECOVERY PROSPECTS ULTIMATELY CRITICAL In the near term, the European leveraged finance market remains in rude health with a healthy pipeline and sponsors rumoured to be sizing up even the largest of publicly listed companies. However, the deterioration in credit quality in Europe, while not reflected currently in the level of defaults that remain well below historic norms, presents a growing risk to lenders.

It is instructive to consider the US default experience for leveraged loans over the 1998-2004 cycle. Over this period, on average, 6.7% of all loans issued with a single-B credit rating defaulted within one year of origination, rising to 11.5% in year two and 15.2% in year three. By contrast, 2.0% of double-B loans defaulted within one year of origination, rising to 4.6% in the second year and 5.4% in the third.

Our expectations of a rise in the level of defaults is only half the story. The other is the degree of loss that creditors may experience after an event of default. Indeed, the protections afforded to senior secured lenders are one of the compelling reasons why institutional investors are so keen to obtain exposure to leveraged buy-outs.

Standard & Poor's has developed a fundamental, credit-driven, scenario-based approach to assessing likely recovery prospects for

Figure 1. Sources of funds for European leveraged buy-outs 2005

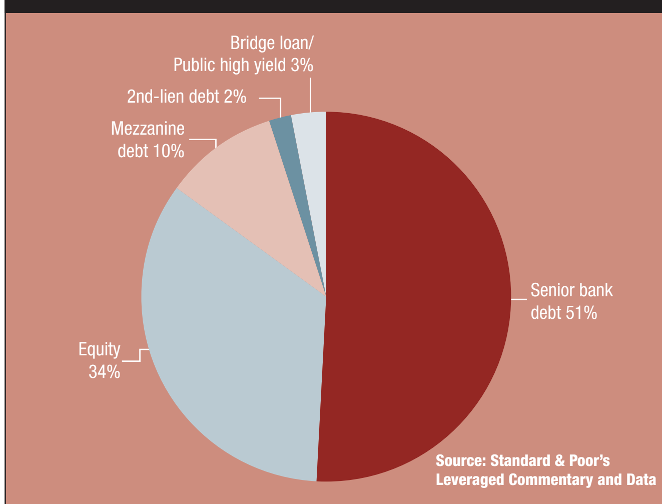
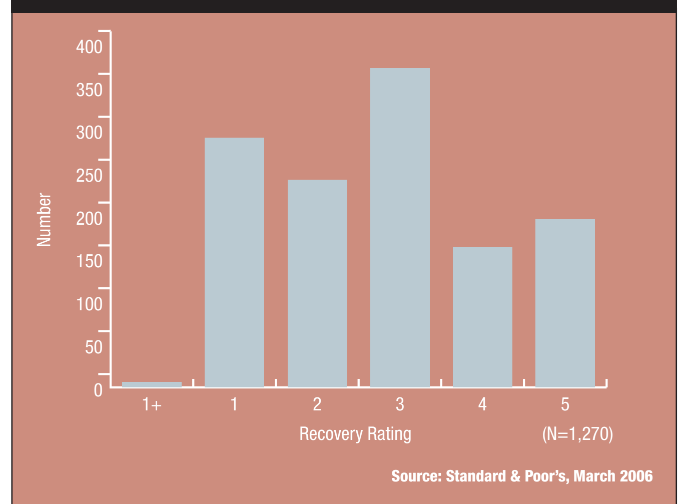


Figure 2. Distribution of recovery ratings assigned globally since December 2003

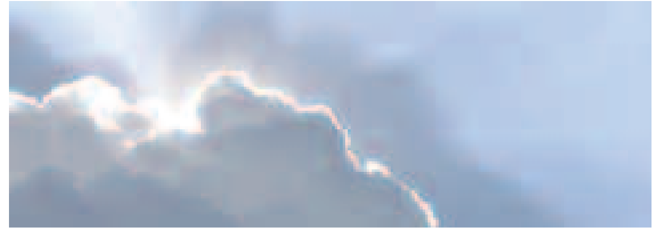


secured debt in the event of default. Four of the critical factors appraised are: the potential timing and path to default, the type and quality of the collateral security, the amount of the loan being secured at the point of default, and the degree of access to and control over the collateral security that the lender exercises.

Individual recovery ratings are assigned to each secured debt issue on a scale of 1 to 5, with 1+ and 1 both indicating at least full recovery of principal. A 1+ rating indicates the highest expectation while a 1 indicates high expectation of 100% recovery of outstanding principal.

Since Standard & Poor's launched this initiative in December 2003, recovery ratings have been assigned to over 1,200 secured issues in the US and Europe. Reviewing the distribution as shown in *Figure 2,* it is clear that the quality of the security can vary substantially even where first ranking security is provided. Nonetheless, almost 25% of the total have been assigned 1/1+. Just under 30% fall into categories 4 (marginal recovery of 25-50% expected) and 5 (negligible recovery of 25-50% expected), although a high proportion of these issues relate to junior secured issues.

CORPORATES START TO FIGHT BACK The rapid changes witnessed in the private equity-driven leveraged finance market has implications for corporate treasurers as the ready availability of debt and equity is threatening the independence of even the largest public companies. It is notable that companies such as Rank have consciously adopted higher leverage and a more aggressive financial policy that has taken its corporate credit rating down to BB-. Linde also intends to adopt a more aggressive financial profile by funding about 50% of its proposed acquisition of BOC through debt, which could lead to its credit rating falling to low investment grade.



From a debt provider's perspective, the default risk has risen substantially and many leveraged buy-outs now have very little financial flexibility to accommodate any shocks. Nonetheless, the ultimate risk of loss depends on the position of lenders in the capital structure and the residual value of the business in the event of a default. Whether the returns adequately compensate for the increasing risk at the various levels of the capital structure is a debate for another edition of *The Treasurer*.

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