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Private Equity Buys Time with Major Refinancings

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IN THE BOOM YEARS OF 2006 AND 2007, European and North American private equity (PE) firms acquired significantly larger businesses, financing the deals with record levels of debt. The borrowings, in many cases, consisted of four- and five-year term loans. When the credit freeze arose on the heels of the banking crisis in 2008, many predicted there would be a flood of defaults when the "wall of maturity" arrived in 2011 and 2012.

Fast-forward to today and it appears as if the industry has sidestepped a crisis. Most PE firms proactively addressed the problem by paying down debt, renegotiating terms, or turning to the high-yield bond market and other sources to refinance, extending debt maturity dates by several years. But that begs a new question today: How will the industry fare if economic and sovereign debt problems in Europe and the United States drag on? Will firms be able to extend maturities again? Or will a day of reckoning simply come a few years later than originally predicted?

In 2014 and 2015, about 1 trillion euros of debt will mature in Europe, and about $295 billion in speculative grade debt in the U.S., according to Moody's and Standard & Poor's (S&P) data. Meanwhile, it is more difficult to borrow than it was a few years ago.

"We have a full credit crunch running in Europe at the moment," says Dougald Middleton, global head of Ernst & Young's (EY) capital and debt advisory team. "You essentially have the European equivalent of the U.S. subprime crisis."

Slow economic growth, or recession, would undermine the performance of portfolio companies, choke the pace of exits and leave PE firms in a weaker position to refinance. And "even in the best-case scenario, it looks like there is going to be a recession in a number of the EU countries [in 2012]," says Wharton finance professor **Franklin Allen**. "That will slow things down globally. Also, China is slowing its growth rate. By 2014 to 2016 we could well be out of it, but we might not be. It's good that they pushed the wall back, but I think things are still going to be tight."

No one welcomes a credit crunch, but specialists at EY and Wharton professors believe the PE industry has recently reduced and pushed back the wall of debt far enough to allow the industry to weather a period of tightened lending, assuming conditions do not get significantly worse. While credit is easier to come by in the U.S. than in Europe, and PE firms in both regions are adapting to an environment in which credit is or may be tight, leverage will remain an integral part of the PE strategy. However, leverage will likely not drive returns to the same extent it has

in the past. PE firms will need to intensify focus on operational improvements in their portfolio companies to boost performance. Above-average returns will be more difficult to achieve, but will still fare above public market indices, enabling the PE industry to attract investor capital, EY specialists suggest.

"There's a lot more healthy formation of capital in the market today than in 2008, when it looked bleak," says Peter Sherman, head of EY's capital and debt advisory group in the U.S. "There's been a substantial amount of pushing the wall [in the U.S.] out to the point where there are no near-term structural problems in the next 12 to 24 months."

Still, the future could be difficult for some firms, and the environment could be more challenging in Europe than in the U.S.

Banks Likely to Stay Their Hand

Starting in 2009, European PE firms responded to the credit crisis by refinancing much of the debt that would have come due in 2011 and 2012, pushing the wall back several years. But debt levels remained high, as many European firms "did little to deleverage the balance sheet," Middleton says. Now the European credit markets have dried up making it extremely difficult for PE firms to refinance or borrow to pay down debt. Fortunately, says Middleton, many banks that lent to the industry are now so weak they may prefer to extend due dates rather than book losses from defaults. "The banks will just have to extend these [loans] again."

Leverage has long been a key to amplifying PE returns, especially in leveraged buyouts (LBOs), but PE firms have never employed the high-risk 10-to-1 leverage ratios found at many large banks, or the 35-to-1 ratios used at some risk-loving hedge funds. From 2000 through 2010, average PE leverage multiples ranged from a low of 3.7 (2008) to a high of 4.9 (2007), according to data from S&P. During 2011, the multiple was 4.4 for large firms and 4.2 for those in the middle market.

Banks are typically borrowing all the time, often in overnight markets, a practice that proved very risky when short-term markets froze in the financial crisis. PE firms, in contrast, use comparatively long-term funding, giving them more time and flexibility to manage market changes, Sherman notes. Though figures vary among firms, a typical LBO investment might be composed of 35% equity and 65% debt. Of the loans, two-thirds might be five- to seven-year debt and the rest 10-year debt.

Among the loans, two-thirds could be bank debt or similar types of loans, with covenants that can be triggered if the PE portfolio company is not achieving its plan or has failed debt-ratio tests, giving PE firms a strong incentive to avoid excessive risk. "Even if you can pay your bills, the guys lending you the money have trip wires to make sure they're back at the table if the business is really not performing," Sherman says. This is obviously why PE firms love covenant-lite loans, which have been more prevalent recently in the U.S. as financing markets are currently robust, he adds.

Another key factor in the risk/reward equation is the price paid for portfolio companies. In good times, prices are higher as a multiple of EBITDA (earnings before deductions for interest, tax, depreciation and amortization), and the ratio falls when conditions are more threatening. In the LBO market, for instance, prices paid by large PE firms peaked at 9.8 times EBITDA in 2007, then fell to 7.9 times in 2009. As the market improved, the ratio moved up to 9.1 in 2011, but only the best performing companies are being sold in this environment.

Further mitigating risk, PE firms can increase the equity component to complete their deals when times are tough. In the LBO market, large firms contributed just 29% equity in 2006, and 30% in 2007, two hot years. Then, as conditions declined, the percentage of equity increased to between 40% and 46% in 2009 and 2010. By 2011, the figure moved down to 37%. When the financial crisis hit

in 2008, poor economic conditions undermined the performance of PE firms' portfolio companies, reducing EBITDA and multiples, thus effectively increasing debt relative to enterprise value. "If you bought a company at the peak of 2007, you were over-leveraged for sure" after the crisis hit, Sherman says.

In the U.S., for example, defaults spiked at nearly 11% of principal outstanding by early 2010, according to S&P data. The number of creditor exits in Europe over the last six years is believed to have been about 10%, according to EY. While some defaults resulted in bankruptcies, many were handled by restructuring loan terms, Sherman points out. The crisis also torpedoed many deals that were in the works but had not yet closed, and it made it extremely difficult to find financing for new deals. Exits fell off as PE firms found that businesses ready for sale fetched offers far below expectations.

As the financial crisis deepened in 2008 and 2009, many in the industry worried about how firms would pay off the debts incurred in 2006 and 2007 that were to come due in 2011 and 2012.

High-yield Bonds to the Rescue

Then came a surprise. "The high-yield market absolutely saved the leverage market," Sherman recalls. In a "big" year prior to 2009, the PE industry in the U.S. would issue about $150 billion worth of high-yield bonds. But in 2009 the figure jumped to $166 billion. Then in 2010 it skyrocketed to $287 billion. Much of this was used to pay down or refinance the LBO debts coming due in the next few years.

As the credit crisis struck, banks and collateralized loan obligations (CLOs) were somewhat frozen, and activity in the leveraged loan market fell off a cliff. High-yield bonds thus became the chief alternative, Sherman says. Leveraged loans to U.S. PE firms peaked at $535 billion in 2007, and then fell to $153 billion in 2008 and a mere $77 billion in 2009.

The surge in high-yield issuance may seem counter-intuitive, as investors tend to flee riskier holdings in times of crisis, favoring safer bets like U.S. Treasury bonds. But yield-hungry investors were eager to buy high-yield bonds, which exceed Treasury yields by 400 to 600 basis points.

"Financial institutions and other buyers were searching for greater yields, and neither stocks nor bonds were very promising," says Stephen M. Sammut, a lecturer at Wharton and partner at Burrill & Company, a venture capital, PE and merchant banking firm based in San Francisco. "They basically made some room in their portfolios for high-yield bonds, and they didn't have to take much to make a difference to the PE industry."

In addition, says Sherman, most high-yield bonds are held by mutual funds, insurance companies and similar institutional investors. Because those investors typically do not leverage their holdings, there was little panic selling of high-yield bonds to meet leveraged vehicle triggers during the financial crisis, making the bonds appealing on a risk/return basis. Put simply, there were plenty of eager buyers for PE firms' high-yield issues while the leveraged loan market shrank because the banks and leveraged loan vehicles, unlike fund companies and insurers, were over-extended and unwilling to offer new loans.

Refinancing the Portfolio

In the U.S. and Europe, much of the money raised in 2009, 2010 and 2011 was used to pay down or refinance the wall of debt that was to come due in 2011 and 2012. "When the market loosened up, issuers gravitated to refinancing [the loans that had] shorter maturities," Sherman says.

Many lenders were willing to "amend and extend" loans that were coming due, often because sticking to the original terms would likely have produced defaults, forcing the lenders to record losses. Indeed, default rates as a percentage of outstanding loan principal fell from about 11% at

the start of 2010 to less than 0.3% in the second half of 2011. Meanwhile, the leverage loan market has rebounded. While still below the 2007 peak, 2011 exhibited the largest volume since 2007, with a 60% increase over the 2010 level.

Together, various strategies currently have left the U.S. PE industry with minimal loans due to mature in 2012, and under $25 billion in 2013, according to data from Moody's and S&P. There is now under $100 billion due in 2014 and $50 billion in 2015.

Fortunately, says Sherman, PE firms can refinance quite quickly when the market presents an opportunity, so there is still plenty of time to deal with debts coming due in two to four years. "People have become more sensitive to maturities, and are more likely to take advantage of a window earlier than in the past, when it was assumed the markets would always be there. If valuations go up, then maybe what I thought was over-levered is not over-levered anymore, because I can sell the asset."

The 2011 Roller Coaster

PE borrowing conditions were a rollercoaster in 2011 -- starting out with some strength, weakening in the summer, picking up briefly in the early fall and then weakening again. The key factor was the changing view of various sovereign problems in Europe and the U.S., Sherman notes. "The market is very sensitive to what's going on out there." That leaves the future very cloudy.

"The financing markets for 2012 will largely be driven by the changes in the economy as is evident by the first few months of this year," says Sherman.

Few experts at present expect the global economy to rebound quickly. "If we get by with a relatively limited amount of sovereign [debt] default, such as what they are talking about in Greece, then things will not be too bad going forward," Allen says. "But if we get more than Greece defaulting, or if we get some exits from the euro zone, then I think everybody will be very nervous about what will happen, and that's going to make the market very difficult for some time to come."

Severe economic and financial problems in Europe would quickly infect the U.S. and other parts of the world, just as the financial crisis in the U.S. spread elsewhere in 2008, Allen notes, adding that, "the fact that China is slowing down is just a huge factor, because we haven't really seen that for a long time." In this environment, firms of all types will be wise to keep debt as small as possible.

A weak economy, with high unemployment and low GDP growth, will be very hard on companies carrying a lot of debt, because there will be little top-line growth to make the debt easier to bear, Sherman says. Conditions are especially tough in Europe, where the looming wall of maturity is huge, economic conditions are very weak and the high-yield market has dried up.

Corporate Competition

Middleton thinks that PE firms in Europe could face strong competition for potential portfolio companies from corporations looking for strategic acquisitions. Corporations have conducted a massive deleveraging, and many have abundant cash to compete with PE firms for promising acquisitions. "The corporate sector is much more likely to be a competitor to PE than it was in the past." At the same time, corporations will likely be on the lookout for healthy firms to purchase out of PE portfolios, creating exit opportunities.

Both the leveraged loan and high-yield markets will improve, Middleton predicts, but he thinks leverage will play a smaller role in PE strategies than it has in the past. There is a silver lining: With less leverage, PE firms may be able to raise money at lower cost by issuing investment-grade bonds. That could be an appealing option, because the European debt crisis could drive up

interest costs for PE firms issuing high-yield debt, Sammut says.

Middleton also expects European economies to go through a protracted period of low growth that will depress demand and make it harder for portfolio firms to achieve profitable growth.

Driving Returns

In this tougher environment, PE firms will have to emphasize operational improvements in the portfolio rather than gains from capital structure, multiple expansion or the rising tide of economic growth, says Christopher Lowe of EY's capital and debt advisory group for the U.K. and Europe. Successful PE firms will probably add more operational professionals on their staffs than in the past and fewer financial engineers, Middleton notes, and they will look to acquire firms with distinct advantages in their markets, like intellectual property, significant market share or pricing power. With low economic growth, PE firms will be wise to focus on businesses that are not capital intensive and have a healthy cash flow, Sammut adds.

Focusing on operational improvements is hardly an unfamiliar strategy, Sammut says. While leverage has been a big part of PE strategies in Europe, the U.S. and Japan, PE firms have often operated without leverage in many other parts of the world. In many regions, banks are uncomfortable with high leverage, or interest rates are prohibitively high, he points out, emphasizing the need to apply a different model.

Another change likely to be long-lasting, says Lowe: Limited partners may have to be more flexible. They may, for example, have to be willing to step in to provide additional capital if the loan markets are not receptive.

The future is cloudy, but the PE industry should be able to adapt, Middleton says. "I think the PE model is as valid today as it was 10 years go. I just think it's going to be a bit different."

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