Hitting a debt end

The lack of liquidity in the credit market has been a thorn in the side of bargain-hunting buyout houses over the last year. Are they now learning to live with limited leverage? By Ashley Wassall

There is a growing sense of optimism in the buyout market. After an almost two-year hibernation there are suggestions that the major banking groups, many of which were on their knees less than a year ago, are again open for business – albeit lending smaller quantities on tougher terms.

Supporters of this opinion point to a handful of deals completed recently containing senior debt packages from clearing banks. Notably, in the UK, Government-backed Lloyds has popped up on several acquisitions, most of which were completed by its private equity subsidiary LDC.

Others, though, assert that this is merely misguided optimism. While a small number of moderately sized deals – most worth less than €100m – have indeed been signed in recent months, deal flow remains a trickle rather than a flood. This trend remains, despite widespread talk of fantastic deal opportunities in the current market.

According to Arno Fuchs, CEO of specialist financing finder Fox Corporate Finance, things are unlikely to change soon. "Logically, banks can only significantly increase lending capacity when their leverage ratios have returned to normal levels. This is something they can only achieve if they reduce the size of their loan books, which takes at least a year or two."

Doing without

The question is, can private equity afford to wait for the credit markets to return to normal – whatever "normal" is. The opportunities coming to market both now and in the near future are touted as being among the best the asset class has ever seen. Now, it would seem, is the time to invest.

The market "correction" has caused a violent swing towards buyers on pricing, exacerbated by de-leveraging in many troubled corporates and private equity funds. In fact, pricing has come down to such a degree that many have been extolling the virtues of all-equity transactions as a way of getting deals done.

Avoiding the need to go to banks to raise capital speeds up the deal process, a distinct advantage to any buyer seeking to close a cheap deal, while the downside effect on returns is seen to be mitigated by an expected sharp uptick in valuations over the holding period.

The argument would appear to be convincing: in the UK alone a staggering 50% of buyouts in Q2 2009 were completed without debt. In the corresponding period of 2007 the figure stood at less than 10%.

But all-equity deals are something of a fallacy. The majority do actually contain some element of debt in the form of a vendor loan, which is effectively a form of bridge financing until the deal can be refinanced. Even those that are completed purely with equity are also likely to see debt brought in when possible.

This temporary solution is risky: if the volume of refinancing needed in the coming years is to be believed – a Deloitte study suggests $9tn over the next four years – there is real doubt as to how easy it will be to raise financing for these deals. Moreover, if high-scale valuation growth does not occur then the returns profile is substantially reduced.

Alternative options

The easier and less risky option is to utilise an alternative source of debt. Undoubtedly, several providers have come to the fore in the last few months, particularly asset-backed lenders (ABLs) and mezzanine funds, both of which struggled over the boom years as the proliferation of cash-flow-based term loans provided a cheap way of financing transactions.

For asset-based lenders, which conventionally utilise a conservative model that involves lending only around 85% of the value of assets, there was simply a dearth of deal opportunities (they even became known in some circles as "lenders of last resort"). For mezzanine houses, even the transactions they did participate in were often high risk for little reward and many such deals are now lingering ominously in legacy portfolios.

Again, though, it is likely that the resurgence of these lending classes represents little more than a temporary measure to facilitate a selection of deals. Mezzanine in particular is rarely deployed in a private equity transaction without (or with little) senior debt, as the pricing would seriously impede on the profitability of the deal.

"Why would private equity houses take warranted mezzanine ahead of senior

debt in a standard deal? It's got to be a special business need to do a deal with only equity and mezz," states Gary Edwards, head of Investec's Growth and Acquisition Finance team.

As for asset-based lending structures, they are most ideally suited to certain (asset-heavy) businesses and are therefore not a viable option for the majority of transactions. Continues Edwards: "Some larger ABL providers that were lending to big deals have withdrawn from the market. There is a need for an alternative thought process: senior or ABL alone isn't fit for all purposes and there remains a gap."

Re-thinking structures

If the currently favoured alternative financing routes are truly merely stop-gap measures, what other avenues are open to private equity buyers? For Fuchs, in the short term the answer lies in making a departure from the traditional buyout model towards partnerships with corporates.

"There are more than enough small- and mid-cap corporates that are looking for equity or mezzanine funding as minority transactions where private equity funds could strike satisfy their target IRR. It seems that most private equity players are so enamoured with themselves and the rules of the buyout model that they are unwilling to seize this market opportunity," he explains.

There are examples of such transactions in the current market, although they are few. KKR recently closed a deal with German media group Bertelsmann, which saw the buyout giant invest an initial €50m for a 51% stake in a new rights management joint venture centred on Bertelsmann's existing subsidiary, BMG Rights Management. KKR has committed a further €200m to build up the business through acquisitions.

But what of the future of the buyout model in the longer term? Rather than being a case of a simple waiting game before senior debt returns in meaningful quantities, Edwards suggests that a re-thinking of the way debt is applied in transactions is required to remove the reliance on inflexible term loans.

Like Fuchs, he stresses that the way the buyout model is boiled down to a system of "norms" is fundamentally flawed. In particular he focuses on the way lending at any given point in the cycle is reduced simply to a market standard (or appetite) multiple, which is then arbitrarily applied to a target business' EBITDA. "It's not about a simple EBITDA multiple, it's about the individual business' DNA, funding requirements over a period, flexibility and debt capacity – management and lender adaptability is critical. There has historically been a drive to normalise structures to allow for volume lending, but people are now looking at the senior debt market and asking if the structure is flexible enough to support businesses," he comments.

Edwards goes on to suggest that a shift in focus will produce more integrated structures tailored to individual business needs. "Over the next two years the debt market may get much more fragmented, with lenders adopting a more integrated approach. You might put in a revolver based on receivables, with a tranche of senior and a tranche of mezz – it all depends on the company and shareholders. Lending evolution must keep pace."

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Beating the cycle

The argument really comes down to making sure that debt is designed to meet the needs of the business it is being put into, as opposed to the wants of the acquiring sponsor or the investing trends of the lender. This clearly didn't happen in some cases in the boom years, with serious consequences for all involved.

For smaller business, it is reasonable to expect that lenders will move more towards less risky asset-based solutions. Indeed, in the words of Edwards: "Asset-based lending could become the *de facto* financing solution for small- and mid-cap businesses."

For larger buyouts, the notion of moving away from standardised structures, designed to allow for formulaic and large-scale lending, could be rejected in the long term in favour of specifically tailored solutions. This is not only potentially better for investee businesses, but could be less risky for individual lenders and more profitable for private equity.

Perhaps more importantly, such a shift in sentiment in the debt market is needed to avoid the extremes of the cyclicality that have been witnessed in the last 20 years, which have been bookended by two major banking crises. Waiting to get back into old habits hardly seems like evidence of the industry having learned its lessons. ■