

EUROPEAN BANKING AND PRIVATE EQUITY

Too close for comfort?

BY MARK WILLIAMS

Buyout houses are taking advantage of cheap bank debt to leverage their European deals. Is this strategy sensible and sustainable, or is the downside too close for comfort?

In Europe, the lending market has reached blistering levels this year. Banks, in a position of overwhelming liquidity, are meeting stiff competition for scarce assets. Debt multiples are rising to dizzying heights, breaking the seven times EBITDA mark on some transactions.

A key reason for high multiples is the availability of attractively-priced debt. A lot of banks, eager to put exposure onto their books, are chasing a limited number of what they perceive to be good credits. Low interest rates, competition for deals and an open syndication market are driving them to lend at desirable rates for borrowers. Although the lending market is extremely liquid at the moment, it has to bottom out sooner or later – but the possibility that debt will become even cheaper is not out of

the question. LBO advisers are happily exploiting the situation, often running two or three banks off each other to squeeze them down to their best terms.

But the banks, not easily outdone, are holding an ace. With competition to underwrite deals so pronounced, the banks that lose out on providing debt in the initial transaction have a second chance to pick up a slice of the pie when the winning lender sells down the debt. Overwhelming liquidity in the syndication market allows banks to stretch their terms, particularly on the big deals, and then reduce their credit exposure risk by getting a good syndication away. "The syndicates for many recently completed deals have been oversubscribed rather than undersubscribed. There is a lot of money out there, so lenders are scrambling to

get in on good deals," says Chris Harrison, a partner at Weil Gotshal & Manges LLP. Considering the amount of money being underwritten on jumbo LBOs, syndicated loan arrangements are vital to spread the risk, and the process is being used freely. "There is no single piece of senior bank debt where half a year down the road the bank still owns all of it. They go down to 10 or 20 percent," says Peter Nussbaum, a partner at Milbank, Tweed, Hadley & McCloy LLP. Of course, some observers wonder whether underwriters are pushing to get deals done to meet financial targets for the year – and leaving it down to their credit analysis teams to worry about syndication later. Even if this is the case, cheap debt will be available until credit analysis teams push back and tell underwriters that their pro- ►►

posed terms on a deal are unfeasible. So far, the multiples have worked and debt for good deals has been fairly simple to syndicate.

One question circulating through the industry is whether EBITDA figures are being manufactured to achieve desired results. By its nature, EBITDA is an artificial financial creation, open to interpretation. From deal to deal, bankers use different cash flow analyses on which to model their ratio packages. As one private equity lawyer put it, such quirks make it difficult to define a standard total debt multiple of seven times EBITDA, for example, because you need to look at how the EBITDA has been calculated for that multiple in the first place. The door therefore opens for a bit of creativity with the numbers. "There is an increasing trend for both headline EBITDA numbers and the classification of debt being massaged by arrangers to mask high leverage. Obvious examples include adding back post buyout cost savings to current EBITDA and treating certain non-cash pay recourse debt as equity," says Colin Atkins, a director at the Carlyle Group. But advisers warn that inflating EBITDA figures is a dangerous game. The same figure used to calculate the multiple will turn up in the facility agreement as part of the covenant, and an exaggerated figure could inhibit the company's ability to repay its debt down the track.

So, is this eagerness to lend on stretched terms a little short-sighted? One adviser believes that much of it comes down to the high turnover of bankers in the industry. "If you find someone who has been through more than one economic downturn you are doing well," he says. This has interesting implications for the lending market. "When a new head comes into a bank, he wants to prove himself. He pushes a lot of money in, gets his promotion and moves onto another job – handing the portfolio over to his successor. The successor soon realises that he needs to get out as quickly as possible, otherwise he will be

the one to take the hit. There is a lot of room for banks to improve in this regard," he adds.

Sometimes, to the outside observer looking back on a failed deal, it seems inexplicable that a bank would take on such exposure. But one lawyer has an explanation: "If you look at the lending market, often even when a business falters the banks do not lose money." As an example, she uses the case of the troubled cable market in Germany, which saw a number of businesses stumble. The banks are now the owners of these companies, and one day will happily sell them. So even if a purchase price of eight or nine times EBITDA is paid, the senior banks may end up owning a business at a purchase price of six times EBITDA. In theory, if the business is not troubled enough to disappear completely, banks are often satisfied to lend because they can be made whole at some point in the future. "General business risks and market conditions can always sink companies, but banks tend to balance out the risk with the rewards," she adds.

But banks are not solely responsible for today's debt multiples. After all, a high multiple is only achieved if an acquirer agrees to it, so the other side to this issue is the role of buyout houses. Mr Atkins believes that the higher leverage on recent transactions has in fact been driven by sponsors willing to pay higher multiples than in the recent past. When assessing the financial engineering of a deal, it makes sense to use as much leverage as possible because it increases the return on equity.

Does this mean that buyout houses have become rash with their decision-making? Not according to many advisers. "Private equity houses are fairly competent and careful when addressing the question of how much leverage a company can take. GPs are being responsible in putting the right amount of leverage on deals today. Remember that they are trying to generate a portfolio return profile, so they are sensi-

tive to the debt ratios," says Mounir Guen, founder and CEO of MVision Private Equity Advisers. This caution comes from an understanding of past LBOs, in which companies were extraordinarily leveraged. Buyout houses at the time were on the lucky side of an economic cycle that probably won't be repeated, and the way that most GPs manage their funds today suggest that the industry has learnt that over-leveraging companies is a high-risk strategy.

As a result, the top fund managers are treating the flushness of capital in the market as a means to deliver inexpensive debt rather than an opportunity to load on too much debt. This allows them to pick up marginal deals that were too expensive before, particularly at the large end of the curve. "Private equity houses are happy to take advantage of increased debt and higher leverage – but within reason. When you have interest payments to make during the operation of the business, it is unwise to overburden it. There is no sense running against the next covenant and being obliged to put more equity in," says Mr Nussbaum.

Ultimately, no private equity firm enters a deal believing it will go south, so plenty of importance is placed on the stability of the target business. "The market is significantly more cash flow focused than during the late 90s and only the most stable businesses are supported by leverage upwards of 7x. The key to success remains fundamental credit analysis and having the ability to decline transactions that are too aggressive," says Mr Atkins. He adds that low interest rates allow stable businesses with a high conversion rate of EBITDA to operating cash flow to successfully operate under a structure that is more leveraged than we have seen for some time.

Although the financial re-engineering side of private equity investment is an integral part of the process it has lost ground in recent years to operational expertise. General managers must ►►

be innovative about the type of debt they put on – be it high yield, straight mezzanine, warrantless mezzanine or various forms of bank debt – and how they arrange the complex structure to unlock value in the company. This lays the foundation for the restructuring of management and operations necessary to move the company forward. "The combination of an intelligent financial structure and an effective operational strategy is what can lead to a break out on the performance – and that's what GPs are looking for. They are working towards a target performance of, say, 2-2.5 times money, but if it all clicks right they could pop to 3.5 times, maybe even four times money," says Mr Guen.

While financial structuring can create some liquidity and free up a company, it does have a cap on how much it can contribute to the business. On the other hand, operational improvement for small and mid-sized companies can have a disproportionate impact on performance. Pushing a company to its next stage of evolution has a profound effect on future returns, making the operational side crucial. "I've seen some fairly fast refinancings to get the debt down and to get some of the value out of the business. But the focus has to be on a buy and build strategy over a two or three year term," says Mr Harrison. The time, resources and skills that buyout houses must therefore devote to newly-acquired companies is far greater than was the case a decade or more ago. The quality of the target company is therefore paramount; it must demonstrate a capacity to respond to change and a predictable ability to grow under guidance.

It's all down to investment strategy. One philosophy in the market is to unerringly seek to buy cheap, as this yields the strongest return. The theory is that if all else goes wrong, at least the private equity firm has made a cheap purchase. If the company reverts to its fair price, they can make their money back, and any addi-

tional rise in value improves return. In the right market conditions, this philosophy may be perfectly acceptable. But competition has made it a fantasy for most buyout houses, who have had to think differently. Today, perhaps surprisingly, larger funds are less and less interested in multiples. "The idea is to focus on the business: the sustainability of the business, the financing of the business and an execution model to develop the business. GPs can be price insensitive if they believe they are buying a company that can perform within their competence," says Mr Guen.

This disassociation with multiples is justified by the return profiles generated by buyout firms who bought at prices others in the market believed were laughably high, then made a killing on exit. Track records like this exist among the top firms, and they are built by following a discipline of examining the quality of any target company. "Creativity doesn't come from improving on the EBITDA multiple of the company, it comes from developing the company," says Mr Guen. If fund managers buy a mediocre company at a high multiple, they can expect problems. On top of the fact that they have paid too much money, financing the business will be difficult and taking operations to the next levels may be impossible. The company is likely to seize up and performance will stagnate or decline. "The lesson is that if you're paying a premium, make sure you're buying a premium enterprise," says one adviser.

Many market participants are concerned that creating value in leveraged companies could be hindered by adverse economic factors in the near future, such as a rise in interest rates. On current modelling, acquired companies can obviously pay, otherwise buyout firms would not agree to these levels of debt. While interest rates are low, companies can cover the debt and interest cover ratios, but if economic factors for businesses start to deteriorate generally, and

interest rates jump considerably, there will be a number of companies in trouble. "Any prudent observer would have to be concerned if we see interest rates go north. These multiples are more common on bigger deals involving strong companies with strong cash flows – but they are still high multiples," warns one private equity lawyer. Portfolios are always sensitive to interest rates, and if they move quickly towards a number that was not in a worse-case scenario configured into the GP's acquisition strategy, this could lead to difficulty.

Top buyout houses are expected to have this angle covered. Mr Atkins is among those who remain unconcerned. "Even if interest rates rise significantly in Europe in 2005 – and I'm not sure that they will – any rise will have a limited short-term impact on the majority of recent transactions as they will have hedged out most of their floating rate exposure. Grohe, for example, is 100 percent hedged for the next five years," he explains. That's fine for the big fund managers, but the mid-market in particular has seen a rapid boom in participants. Some of these new players are buying companies in line with different business models. It all comes back to practice. A competent buyout firm will anticipate different variables or scenarios that can affect their holding – including rising interest rates – and prepare a contingency plan. But for some of the mid-market funds that are just building their firms and their portfolios, there might be a sudden, unfortunate realisation that they are exposed. "There are pockets in the market where risks will arise, particularly among younger firms. Experience and corporate governance count for everything here," says Mr Guen.

Of course, whether or not buyout houses are overpaying for deals in today's market, and whether they have the experience to pull themselves out of trouble if the market turns, is all speculation until they exit the investment. ■