

DEBT'S SHAKY RETURN > THE BRIBERY ACT AND PRIVATE EQUITY

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FOREVER BLOWING BUBBLES

Private equity is only just recovering from its latest wave of excess, but a new bubble may already be forming.

FUNDRAISING: INVESTORS CONTINUE TO RESIST EUROPEAN VENTURE'S CHARMS





THOSE WERE **THE DAYS**

The continued shortage of debt means that private equity may struggle to return to its former glory.

WORDS **VICKY MEEK**



FROM UNEASY WHISPERS TO EXCITED

murmuring – and now to full-blown cries – we are increasingly hearing that debt is back.

Just 18 months ago, private equity was still languishing in the doldrums, with portfolio companies crumbling and debt scarcer than hen's teeth. Fast-forward to today and the picture is very different. Deal activity is not stratospheric, but there is a new confidence in the buyout market as firms take advantage of a more liquid debt environment.

This is especially true of the larger end of the market. "We've seen a significant pick-up at the bigger end of the loan spectrum – for companies with Ebitda of €250m or above," says Neil MacDougall, managing partner of Silverfleet Capital. "There is a lot of interest from lenders." He adds that he was recently speaking to a senior figure in the leveraged loan department of a major bank, who said that there was currently too much competition for business.

This competition is coming from the credit markets, as well as banks. High-yield bonds staged a comeback last year that shows no sign of abating. "The high-yield bond market has historically been closed for long periods, particularly on the back of macroeconomic disturbances," says Richard Clark, a director in DC Advisory Partners' debt advisory group. "This has meant that it's been hard for companies to rely on this as a source of credit. That is starting to change with the market remaining open for sustained periods."

Even events that previously might have destabilised the bond market have failed to shake confidence. "Historically, what has happened in Japan, Libya and Portugal may have closed the high-yield bond market for a long period," says Clark. "One of the drivers is a search for yield among investors in what has been a low interest-rate environment. That won't last forever but we may see Europe follow the US, where there is a well-established bond market driven by institutional investors."

He adds that this could be a longer-term trend as regulatory changes start to take effect in Europe. "The contrast between the US and European markets is diminishing," says Clark. "The US has historically been more institution-led but, post-crunch, it looks as though Europe may move more in that direction as the banks retreat, pushed in part by capital adequacy requirements."

Hello CLOs

We've also seen the re-emergence of CLO and CDO vehicles in many markets for the first time since the boom years – and that's adding to the competitive tension. "Liquidity for the larger deals has been helped by the return of the CLOs," says Clark. "They have more liquidity because they have seen a number of their credits refinanced, in particular through the high-yield bond market. They don't want to return cash to investors, so they are keen to get capital out the door."

Clearly, this competition is having an effect on the quantum of debt available and the terms on which it is lent. In the US, there has even been a return to cov-lite structures. Indeed, in the first

two months of 2011, 25 per cent of new syndicated loans (worth \$22bn) were cov-lite, according to Standard and Poor's LCD.

While these have yet to reappear in Europe, the structures being used now in larger transactions are shifting, with non-amortising debt once again becoming a feature of deals. "There are a lot of signs of confidence in the debt markets," says Penny Angell, partner in the banking practice at Hogan Lovells. "Senior debt multiples have crept back up to 4.5x Ebitda for some deals. Some of the debt going into deals has been structured as a non-amortising tranche in response to the re-entry of funds to the credit markets. We're even seeing reverse margin flex. As a consequence, it's now much easier to get larger deals away."

Clark agrees: "We've seen a shift in the quantum available. Last year, it was difficult to raise more than 4x senior debt to Ebitda. We are now seeing many examples that have achieved over 4x." Indeed, Integrated Dental Holdings, acquired by The Carlyle Group and Palamon Capital Partners; Blackstone Group's recent acquisition of tin manufacturer Mivisa; and CVC Capital Partners' deal to buy the Spanish arm of Swedish healthcare group Capiro are all believed to have been completed with more than 4x Ebitda of debt.

Statistics also back up anecdotal evidence of an upward trend. In 2009, total debt multiples seem to have reached a nadir at a 4.46x Ebitda average for European deals over €50m, according to S&P LCD. This was the lowest multiple since 2002. Of this, just 3.25x consisted of senior debt in 2009. By 2010, multiples had crept up, with 4.59x Ebitda of total debt going into deals, of which 4.09x was senior debt. And much of the increase in average is accounted for by the second half of the year.



"The cost of debt has almost doubled since the crisis. Debt availability has improved, but fewer banks are providing it and there is higher demand"

"We have also seen reverse flex on many of the larger deals during the syndication process in 2011," adds Clark. Recent examples include Bain Capital's acquisition of IMCD and 3i's deal to buy jewellery retailer Amor.

In fact, the turnaround has come as a surprise to many in the market. "If you look back two years, it was still possible to get some debt from the clearing banks, but they were underwriting amounts of between £20 and £25m," says Philipp Schwalber of HgCapital. "But debt has come back as bonds have returned to the market, making banks more aggressive. We're seeing some pure non-amortising debt and even PIK notes now."

MacDougall says: "Banks are now talking about lending levels to businesses above what we think is appropriate. Of course, it depends on the quality of the credit and, if a company has been resilient through the downturn, then 5x Ebitda isn't outrageous. But it's quite a jump from just two years ago. Back in 2009, if we'd asked to get more than 3x Ebitda, people would have looked at us as if we were crazy."

Bullishness is back

The debt markets have recovered to such a point that dividend recapitalisations have returned (see box, left). And we're even seeing the megabuyout chiefs predicting a return to \$10bn-plus private equity deals. At the recent SuperReturn conference, TPG founder David Bonderman said: "Larger deals are back. It is absolutely possible to do a \$10bn to \$15bn deal now. It might not be the one you want to do, but the capital is available."

Given all this, could private equity be back to its "glory days"? Is this really a market in which only moderate amounts of debt are available?

At a surface level, the answers depend on the size of deal and the market you are in. Below the larger deal segment, it remains tricky to get acquisition finance packages in place. "There is a bifurcation in the market with significant appetite for deals at or above €200m," says Robin Menzel, partner at Augusta & Co.

"Underwriter economics allow for about €4m of fees to be skimmed when selling the loan into CDO/fund markets and, if that fails, the underwriter can sell the deal into the high-yield market. High yield is on fire - almost anything at or above €200m will get away."

"Yet below that level, it is a take-and-hold market and we have to assemble small clubs of lenders. Banks increasingly have a home-market focus and only a few foreign banks continue to lend. In the UK, after RBS and Lloyds, we only see Clydesdale (National Australia Bank), Investec and Macquarie active."

Again, this is quite a turnaround from a couple of years ago, when the mid-market was the only part of the industry able to get deals away. "Out of the downturn, the mid-market rebounded first and private equity focused on smaller deals where club financing was available," says Menzel. "Now, with repayments fuelling CLO liquidity, large credit funds having raised new money, and

RETURN OF THE DIVIDEND RECAP

Critics of private equity often point to the fact that the industry was able to take money off the table by leveraging the companies it backed during their hold periods in the debt market's most frothy period (between 2005 and 2007).

The crisis saw off this type of deal, as increasing the debt burdens of already leveraged companies was considered a complete no-no. Yet, curiously, we are now starting to see dividend recapitalisations return to the market. Indeed, Bain Capital refinanced French chemicals business Novacap last autumn ahead of its sale to Axa Private Equity.

"Credit markets have recovered to the point where we are starting to see dividend recaps again," says Richard Clark of DC Advisory. "Generally in 2010, the recaps that were completed used the high-yield bond market, but the appetite among banks is

starting to re-emerge and we are seeing a number of private equity houses seeking to tap this source of finance to take cash out of the business and de-risk ahead of a sale."

And oddly enough, it's a revival that appears to be driven in part by the banks rather than, as critics would have it, sponsor greed. Some say that banks are even approaching sponsors with the idea of completing dividend recaps on a selective basis. "Clearly, banks are considering this on a case-by-case basis and the business can't be too highly leveraged, but it's an indication that the credit markets are recovering as lenders see that the world hasn't come to an end post-crisis," says Clark.

It seems as though we should expect more - if banks are willing to offer these deals, sponsors looking to exit might be hard pushed to refuse.

continued inflows into high-yield funds, the larger deals are getting away, while it's often a struggle in the mid-market."

MacDougall agrees. "It's much harder to get finance for smaller companies," he says. "Those that are more exposed to, say, the UK economy or that are in unfashionable sectors will struggle to raise debt."

That said, it really depends on where you are fishing. In some European countries, the situation is a little less difficult for the mid-market players. "At the smaller end - up to €100m - it's a mixed picture across Europe," says Clark. "In France and Germany, there is plenty of liquidity as regional banks are keen to come in where there is a local angle. Where there is less competition from regional banks, for example in the UK and Spain, pricing has remained relatively high." Where once the Icelandic and Irish banks fed the UK mid-market, these have now gone, leaving the competitive field relatively empty.

Some in France and Germany simply see the current situation as a return to normality. "At the lower end, leverage levels are in line with historical norms," says Eric Bismuth, chief executive at Montefiore Investments. "We're back to 3.5x Ebitda as a reasonable amount to expect to raise for most companies."

The bad news

However, even despite the hot debt markets at the top end of the spectrum and some availability in the mid-market, there are concerns. Debt remains expensive and is still harder to come by than previously. "The cost of debt has almost doubled since the crisis," says Holger Kleingarn, partner at Palamon Capital Partners. "While you used to see margin structures of 2.5 per cent, they are now in the region of 4.5 per cent. Debt availability has improved, but there are fewer banks providing it and there is, therefore, higher demand from these banks. The terms are often tougher in terms of covenants, and banks are looking for earlier repayment schedules. Banks are clearly focused on getting their money back and generating higher fees."

"The players in the market are not the same as they used to be," says Mark Tagliaferri, managing director at GI Partners. "Credit committees have more power, the focus on due diligence is greater, the margins are higher and you have to work a lot harder to get where you want to be."

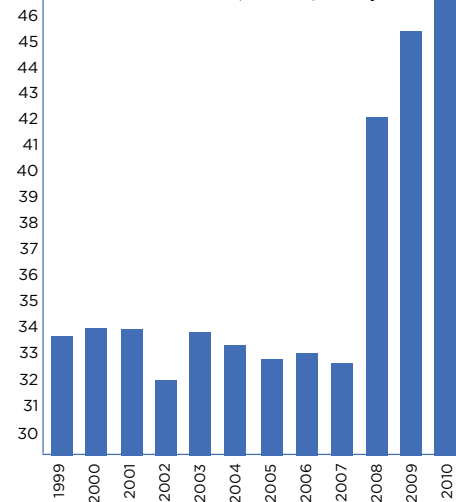
In fact, even despite greater competition among lenders, pricing remains stubbornly high. "There is a fear among lenders that margins will reduce," says MacDougall. "But we haven't seen much movement. At the larger end, people have been able to flex margins down, but only by around 25 basis points to, say, between 4.25 per cent and 4.5 per cent, where you used to be able to get packages at two per cent. In the mid- to lower end, lenders are holding firmly to their pricing, though."

Equity cheques also remain high, although they have come off their peaks and may reduce a little over the coming 12 months. The fact is that lenders still expect sponsors to stump up a large proportion of the transaction price, with some deals seeing equity structures as high as

EQUITY CONTRIBUTIONS ON THE UP

While we are starting to see equity cheques from sponsors lower slightly at the larger end of the market, it's interesting to note that the average equity component in European deals actually increased in 2010, and in the first two months of 2011, it rose further to a record 47.2 per cent. In the US, meanwhile, the past two years have seen a reduction of equity contributions, with the average falling from 45.7 per cent in 2009 to 41.4 per cent in 2010, and 37.5 per cent for January and February 2011. Will Europe follow suit?

Average equity (%) contributed in LBO transactions (€50m+) Europe



Source: Standard & Poor's LCD

70 per cent. And that will impact returns. "Debt capitalisation ratios have come down from the mid-60s to 50 to 55 per cent," says Menzel. "Equity returns will come down because deals are being over-equitised and prices remain high. I expect the 2009 to 2012 vintages will be poor, which is a reversal of what we usually see in a downturn. In the past, there were cheap businesses available. This time, it's distinctly different. Multiples remain high as private equity is awash with uninvested funds, while banks, having been bailed out by their governments, have not needed to sell assets, which has limited supply."

For some, this is a permanent and significant shift in the market. Private equity firms that relied on leverage for returns will suffer, they say. "We saw this coming," says Kleingarn. "We never leveraged our companies too much because we always felt that the right strategy is to back companies that have growth potential. They need surplus cash and enough headroom to invest to help them move into new business areas or expand internationally. The debt markets are not going to bounce back to previous levels, but the fact that debt is less available and more expensive, and that more equity needs to go into deals, doesn't make a difference to returns if you have a growth strategy."

Gunning for growth?

So does this mean we'll see firms start re-inventing themselves as growth investors? Not necessarily, says Kleingarn. "We've always asked ourselves whether buyout houses will try to get into our part of the market," he says. "But you need the right skill set and DNA - these are very different from those needed to execute financial engineering transactions. And even if you can introduce them into a firm, that takes time and it's hard to convince targets that you have the right skills - you can only win deals by paying high prices."

Instead, those at the larger end will have to diversify to mitigate the effects of lower returns, he argues. "Larger players are already going into other areas, such as real estate and hedge funds, because the classical leverage model is getting

harder," he says. "It's not an easy space and we might well see people having to settle for lower returns as a result - EV multiples are already up significantly and if you have a situation where pricing is up, but so are equity cheques, you get into an environment where IRRs are consistently lower than they have been historically."

Yet while most would agree that returns will come down, they believe that the new reality of more expensive and moderated levels of debt need to be seen in context. "If you look at the return on cash globally, it's close to zero," says Schwalber. "Private equity won't necessarily achieve 30 per cent IRRs, but it will certainly outperform other asset classes."

Tagliaferri agrees. "Most sponsors are still looking for 20 to 25 per cent returns for private equity," he says. "That should be achievable from where we stand today."

So, while we are seeing signs of frothiness in the debt markets, it looks as though the premise of moderated debt levels is actually an accurate one. Firms will need to look closely at what they do and how they are going to achieve the returns they have promised to limited partners. Some of this may require a re-organisation of resources. "Liquidity has returned to the debt markets much more quickly than many had anticipated," says one adviser. "That said, the future will be harder for private equity. To be successful, they will need to boost their origination capabilities and become less reliant on secondary buyouts. Not all firms will survive at the same levels as previously."

And, of course, your view on whether private equity can return to its glory days depends on your view of when these actually were. For many, today's market is just a return to the norm in many respects. "I'd say the boom times weren't glory days, but rather, gory days," says MacDougall. "In early 2007, you could get senior and subordinated debt packages totalling 8x Ebitda. We're some way off that kind of insanity now and we're seeing a much higher level of amortising debt than previously. These are signs of a healthier market." ●

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