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Roundtable

WITH EMANUEL EFTIMIU

One year into the credit crunch, five industry representatives came together in August 2008 to discuss the current state of the debt markets and the implications for private equity. Issues debated included liquidity, deal structures, default levels, distressed debt opportunities and the outlook for the future.

The Panel



Jochen König,
Head of leveraged
finance Europe,
Royal Bank of
Scotland



Robin Menzel,
Partner,
Augusta & Co



Rolf Nuijens,
Director,
Intermediate
Capital Group



Jon Moulton,
Managing partner,
Alchemy Partners



Gary Edwards,
Head of growth &
acquisition finance,
Investec

Emanuel Eftimiu

The latest stats from our Private Equity Insight database show that European buyout activity in H1 2008 has dropped by a third year-on-year and, more dramatically, value is just one third of where we were in 2007. What is your view of the market at the moment and what effect has the credit crunch had on deal structures?

Jochen König

There is a positive trend in the market as we had a very slow first quarter with a better second quarter. In terms of structures, we have seen a complete change compared to the first half of 2007 with a revival of the amortising A term and more mezzanine, which is now taking portions of 1.2-1.5x. Pricing has also increased – I would say by roughly 75-100bps on the senior and 200-300bps on the mezz. There is no second lien in new transactions – anything you see in the statistics is done purely out of legacy deals. Finally, leverage multiples have started to come down to an average of 5-5.1x EBITDA, although not all statistics reveal this because of the influence of legacy deals.

Robin Menzel

At Augusta we typically advise in the €50-300m mid-market space, where we are now structuring senior debt at no more than 3-3.5x EBITDA. Everything thereafter is mezzanine or equity. We are trying to place a split senior and junior mezz tranche and, though we haven't succeeded in doing that just yet, I expect the market will allow this soon as there is more money flowing into mezz funds. Pricing for mezz is now anywhere from Libor+12 for smaller deals to Libor+18 for distressed situations, involving a cash pay and a very large PIK element. We are also increasingly seeing warrants.

Rolf Nuijens

We definitely get many more calls now than we got in '06 and '07. The sponsors are actively looking for mezzanine – they have to. Banks ring us up for €20m of mezzanine, something they would have never dreamt of calling us for before. In the first six months of this year, we've seen a flow of capital into leverage finance by those banks that were not able to play in the last years. The same applies for some of the mezzanine funds – there was basically no mezzanine in '07 and there was a bit of mezzanine in '06 but most of it got flexed out. All of a sudden these mezzanine funds now had a big opportunity to deploy some capital and that's what they've done. But now that sort of excess has been used and you are starting to

see mezzanine investors becoming much more selective, which is why pricing has gone up sharply. Mezz investors are long term investors and most of them have had experience of rough times. With a worsening macroeconomic outlook they are more careful and only select the best deals with the best structures. If they don't like it, then they'd rather pass and wait for the next opportunity.

"Banks ring us up for €20m of mezzanine, something they would have never dreamt of calling us for before"

Rolf Nuijens, ICG

Jon Moulton

Actually, the market is really where it's been in quite a number of years although in scale it's a lot larger than it was 10 years ago. Yes, it has collapsed, but it was ludicrously over inflated and now it's come back down to a little on the conservative side of where it ought to be, but not dramatically so. Now we are in a simple market with simpler structures. There is no right answer for the long term level of debt, but it's more like 4x EBITDA for senior than 9x adjusted, normalised, proforma EBITDA with the date added in, which is what we were doing last year. The only sort of novelty we're seeing is a few offers of senior debt from hedge funds, which are offering two-year facilities at 11% fixed or so, which is a peculiar piece of paper to fit into a deal however you do it. On the other hand the banks don't have much capital. We're doing a deal at the moment and it was a little challenging getting the bank to actually underwrite having said they'd do it. They wanted to pre-syndicate it but were not able to.

König: I don't think it's all doom and gloom. We have looked at roughly 70 transactions in Europe up to June and have structured 18. There is no doubt that most of them have been clubbed structures because it's a club world now. We have also done several on 100%. Yes, there is a lack of liquidity due to the disappearance of institutional money from CDOs and CLOs, but on the other hand we see fresh liquidity coming into the market from hedge funds, debt funds and opportunity funds. We have seen very large transactions like Expro, Abbott, Converteam, Convatec and Biffa being done – all deals with more than €1bn of debt. Even deals like Xella, which is construction materials – probably one of the toughest sectors to do currently – has been done and the syndication worked out well. Of course it's clubbed, it's pre-sell, it's hard work and it takes longer, but the market works and I think the trend is positive.

Gary Edwards

Generally, I think the markets are exactly where they should be – part of the problem is that a lack of transparency from some banks causes more

confusion. Banks just aren't disclosing their true appetite to lend. They're saying they're open but then just hoping they either lose the deal naturally or the deal dies a death and goes away so they can exit the discussions gracefully. The worst case scenario is when they scale back or revise terms prior to close and jeopardise the transaction. Yes, some banks are in pain but that's just the reality of life. At least we're back now at some sort of

normality and debt markets are actually structured the way they should be. Eighteen months ago, as an asset-based lender, I was structuring deals where I could get to a £20m debt figure with appropriate debt service capability and a bank would walk in and offer a 6x multiple on "future" projections giving a greater quantum of debt. You'd think: "that's completely irrational," a debt structure that requires

future double digit growth to debt service is equity funding – not debt – and should have had equity returns.



König: In terms of liquidity, we have seen a role reversal between banks and institutions. Pre-crunch liquidity was made up 30-40% by banks and roughly 60% by institutions – now it is the other way around. The problem is that bank liquidity is limited due to a lack of profitability and the economic outlook. And, of course, there is Basel II, which has doubly affected banks: On the one hand it limits new business because of higher RWA requirements, but on the other hand it punishes deteriorating business on the book with a much higher risk-rated asset burden. This again limits the banks' capability to lend. Going forward, bank liquidity has to be viewed not as a constant volume, but as something that is quite volatile, impacted by the equity markets, the economic outlook, Basel II requirements, the regulator etc.

Eftimi: With syndication being more difficult, are underwriting offers more restrictive in terms of flex, demanding full structure or market flex?

Moulton: On the deals we've done so far this year we had syndicates of three banks. Bearing in mind the high margins, the high fees and

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König: We have already seen a doubling of the default rate. If you look at the global default rate, it has doubled from 1.2% to 2.5%, but the historical average is roughly 4.5%. If you talk to distressed debt investors in the market, they believe they will see 5-7% and higher.

Moulton: If you go back to the last, good old-fashioned bubble in the UK in '89/'90, about 25 pence in the pound of the principal was lost on senior debt. So things can be massively worse than we're used to. The idea that it would go to 7% is all too plausible, and particularly as we're talking about a population of debt that

the pre-syndication, banks aren't going to do additional distribution so why would they need a market or structure flex? Where somebody's taking on 100% with the intent of sub-participating three quarters of it, of course they demand flex as they're nervous about the risk. That does then give tremendous transfer risk to the equity houses if we have yet another of these regular nasty surprises happening in the financial world.

König: RBS is very active in the mid-market, although not below €100m debt, and of course we ask for flex when underwriting. Whether we use it or not is another matter. I think there is very clear wording in this regard – “successful syndication” – and the flex triggers if you're not there. We have seen extremely borrower-friendly documentation over the last two years, which has now been reversed. You might not need some of the triggers at the end of the day, but you have to tick the boxes to present a strong case to your credit committee.

Eftimiou: What if market liquidity rises again? Will we see an increase in deal activity or do you think that there's a lack of sensible deals in the market as well?

Moulton: Currently there's a lower flow of deals into the market as you don't find many sellers in a weak market. On the other hand if there was a rapid turn-on of cheap and available debt, rest assured that history tells you prices would go roaring away and deals would follow with a lag measured in months. The debt is a limit, but the other thing that's happened this time round that we haven't had for a very long time is the possibility of recession all over Europe – very sudden, very rapid. We are going to see a lot of defaults and we're going to see a lot of forced sales out of the leverage buyouts. I suspect other people's large leveraged buyouts will be a major source of deals for me over the next year, as they're forced to sell some of their better bits to pay the interest on the totality.

has no relationship to history – multiple layers, multiple jurisdictions, massively higher multiples – and then a hoard of investors. Then you have these complex structures with peak year for amortisation on big buyouts around 2012/13. So many companies are going to have to struggle along with unrefinancable debt loads for as many as five more years. You've got a long period of living dead companies that are going to fail and are fighting on the edge of liquidity. All this of course will generate a lot of opportunity both for distressed debt players and equity players.

Nuijens: Once default rates go up everybody in the industry will be busy working through this wave of defaults and will not be working on new deals, which will then be even more difficult to structure. I think we will start to see people losing money, even on senior debt – it's inevitable when you look at the highly leveraged structures put in place in the last two years.

König: And current reliance on banking liquidity is not helpful as banks are much more sensitive towards these events. Despite the current default rate of 2.5%, a look at portfolios shows that companies are facing difficult times. Several sectors, such as retail, are currently very challenging to structure. It's a bit easier if you're closer to energy or raw materials but still very tricky. We've already mentioned construction, which is not just a UK problem, but prevalent in Spain, the Netherlands and Ireland. House prices have even started to tumble in France. Having said that, there are still regional segments all over Europe where deals can get done and where sometimes local liquidity is even significantly cheaper than the European market standard.

Eftimiou: So with defaults seemingly inevitable, how difficult are the restructurings going to be?

Nuijens: Well, first of all you will have to deal with all the other lenders involved – sometimes you get 20, 30, or even more in one transaction.

Menzel: A frequent problem is the requirement for full consent from all lenders in a consensual restructuring. In many situations we can not use majority consent to cram-down decisions as binding on all lenders and some will abuse their “hold-out” ability.

Moulton: Give us 100 or forget it! Go back to ‘89/’90: I have fond memories of Bank of America refusing to agree to a change of accounting date so that they could get repaid in full out of a syndicate they didn’t want anymore. These things happen. We have these complicated structures with somewhere between three and 11 layers of debt that were traded heavily, but we actually do lack some other Chapter 11 cram-down tools to make restructurings happen. Cram-down is something that I think we sincerely need, otherwise the games that are available to be played now are unlike any previous banking crisis. For example, you can hold an absolutely worthless junior level on any economic analysis but are able to hold everybody to ransom throughout the structure by holding 26%. Or you can hold 26% of the most senior bullet proof layer and hold everybody else to ransom. At worst, of course, you can have two people in every layer holding everybody to ransom. It could be total chaos and we don’t have a system to deal with it – that’s a real problem. Some sort of rulebook will have to be installed, otherwise when these companies get in trouble, there will not just be economic damage – there will be job damage and social damage from companies that can’t be restructured in reasonable time frames.

“We have these complicated structures with somewhere between three and 11 layers of debt and we lack some Chapter 11 cram-down tools to make restructurings happen”

Jon Moulton, Alchemy Partners

Edwards: Without a cram-down process you’re not going to have what you hope. There are businesses out there that have good products, good people and good management. It’s not the business that’s distressed – the business is fine – it’s the overly optimistic financial and debt structure that was put into it that causes the problems. Viable businesses should not be dragged down because of a previous poor banking judgement, a pragmatic approach must be taken by all sides.

Nuijens: It would be great if you didn’t have to negotiate with all the different creditors. You could sell in a going concern – it would be a great opportunity for anyone buying. But if you have to do a workout with all the lenders and creditors, it will be a disaster.

Eftimiu: According to latest estimates there are \$32bn of distressed debt funds currently being raised. What opportunities do you see for these funds?

Moulton: The total available market is probably about \$1.8tn and growing. There’s a plethora of opportunities and not just in leveraged loans and property. The billions that are being raised can be invested, the question is will they make good returns? For the last year, most investments in distressed credits have seen further reductions in value. A lot of CDO debt has been traded straight into another loss – from one loss to the next. At some stage, that will turn dramatically but I’m just not sure when. Then there are still a lot of credits to come out of banks’ balance sheets. It’s the easier credits that have mostly been traded out so far but there are many more left sitting on their balance sheets at various different prices.

Eftimiu: Are you expecting these credits to come out at some point?

Moulton: Yes, but how and when is anybody’s guess because the different provisioning policies of the banks are extraordinary. At least one of the large UK banks doesn’t appear to have taken any noticeable provision against a very large portfolio – others have taken very aggressive provisions.

Menzel: We are starting to see banks pruning their portfolios and this will accelerate just as it did during the last downturn when a lot of banks exited LBO lending. Bank liquidity is already significantly reduced and there are several stressed or zombie banks walking around that cannot attract funding or additional capital and so have had to curtail their lending and shrink their balance sheets. Others are being sold or merged. When you merge banks, as with Dresdner and Commerzbank, the combined loan portfolio generally needs to be reduced significantly to avoid concentration risks. This is adding to the selling pressure with loans having to be sold into a falling market, which will provide very interesting opportunities for restructuring and distressed investors.

Nuijens: We distinguish between distressed and stressed opportunities. Distressed is when the company is in trouble and you are buying a position in the debt to actually hold everybody to ransom and get a good return for yourself, which is pretty difficult. Stressed on the other hand is buying perfectly fine assets from forced sellers. These might go through a bit of a rough patch but will ultimately survive, hopefully providing you with attractive returns. These opportunities are interesting for us as mezz investors but I’m not sure whether they

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are as interesting for an equity investor. That depends on the discount and whether their LPs accept such investments.

König: I think we will see more sponsors putting additional equity in their struggling portfolio companies, which were previously structured with rather limited equity portions. With few other investment opportunities around and large funds available they won't let the company default but rather use equity cures – and we have seen this happening already this year. Partly there is also a reputation effect – not to be overestimated but existent – as the sponsor's track record is important to get into the auction, especially in times where less deals are around.

Nuijens: That's true but I still doubt that the flow of fresh money from sponsors into difficult deals is going to be very big. I think that remains very limited, particularly in deals where the sponsors have already taken all the money off the table.

Menzel: Although protective of their reputation, I think private equity houses first of all have a fiduciary duty to their investors and in distressed cases these two imperatives are clashing. At the smaller end, we're seeing some GPs simply handing back the keys to the company to creditors. They were often playing a financial leverage game; making single bets, piling debt onto a business and putting it into considerable financial stress and so requiring management to work like mad “popping rivets” to safeguard the business, and then selling on that heightened performance. Consequently, many are often more interested in making new bets rather than worrying about any old failed bets.

Edwards: In the mid-market, the qualities and motivations of the management teams are our first decision, not our last decision. It's management team first, compelling business next and then we put the financial structure in behind. If the management team lose incentive, they're going to walk. As a management team are they really going to “bust a rivet” for a private equity firm investment or stick with a long recovery if there's no personal value creation?

Moulton: Keeping people motivated in a company that's in serious financial trouble has always been difficult. Yes, of course there's a problem in incentivising management on the down – no exits in sight, or very few, with much lower returns. For a period, the management are going to have to worry more about job security than getting rich.

Eftimiu: But with the markets in the midst of this downturn, why have valuations remained stable?

Menzel: One countervailing force we see against the five negative factors driving the market - falling bank liquidity, funds retreating, weakening economies, rising defaults and complexity of workouts - is the strong demand from strategic buyers. We're seeing surprising demand from strategics, who rather than waiting for the knife to fall are happy to go and buy an over-levered buyout now.

Moulton: Our recent disposals, which are not that numerous, have all been trade and, in some cases, there has been fierce competition amongst them.

König: I think valuations are starting to come down now. Up until the end of the first quarter we saw valuations above 10x EBITDA in Europe, but we have now seen the weighted multiple moving down to around 9-9.5x.

Eftimiu: We've had a buoyant fundraising market in the past and there's a substantial equity pile that is still waiting to be deployed. Is there any room for more fundraising at the moment?

Nuijens: The issue with LPs is that over the past four or five years they have been building up their private equity allocations. Private equity funds

returned money very quickly and this money had to be reinvested so it went back into the next fund. With lower exit activity this flow has stopped and LPs are not getting any money back. Additionally, relative to other assets in an LP's portfolio – quoted stocks for example have

all gone down – private equity has now become more sizeable; close to or larger than their desired allocation for private equity.

Moulton: This is a very powerful effect that people forget. LPs who have a certain private equity allocation in their funds have seen their overall fund sizes decrease in the past year, which automatically increases the private equity allocation percentage. All of a sudden, LPs find their allocation to private equity to be more like 8% or 9% when it is really meant to be around 5%. That's going to give rise to a really dramatic switch off of funding over the next few months. Fundraising is not a nice, smooth sine wave – it'll definitely have a cliff to it and that cliff comes now. So this will eat away at the equity pile together with what will inevitably now be very poor returns for the '06 and '07 vintages, which of course are the largest vintages of funds ever. The cycle will turn and 10 years forward it will look a bit different.

“It's not the business that's distressed, it's the overly optimistic financial and debt structure put into it that causes the problems”

Gary Edwards, Investec

Eftimiu: So what is the overall outlook for the coming years?

König: No one can tell how harsh the recession will be. We have seen some large transactions starting to tumble, but the refinancing costs are quite under control. Also, we do not believe that the funding costs will rise dramatically in Euro or Sterling. A rise will come in the US, but I don't expect the Bank of England or the ECB to raise funding

attractive to them. I also take comfort from how much volume has actually traded and how fast new money has come into the leveraged loan asset class. I know several CDOs that have gone down from €3bn to €1bn – they've each traded out of €2bn of assets. Yes, prices have dropped 15-20 cents for performing credits, but the considerable volume traded is a positive for the market's outlook as assets can go to those that can actually fund and hold them.



costs dramatically as there is no room for this. We have seen the market recover from the worst liquidity crisis ever. Now, with a looming recession people are focusing on businesses they believe are recession proof or at least not cyclical like health care or waste management. And they put good and sustainable structures in place with 4-5x leverage.

Moulton: A recessionary effect is beginning to be a lot more visible in the leverage loans, where companies that have been struggling along for long periods suddenly have a real lurch down. Then there are obviously sectors that will stand even quite savage recessionary scenarios. None of us know anything really with any certainty other than we are in a decline and that a recession looks more likely than not.

Nuijens: I think that, as the liquidity that was coming to every single market in the last years has now stopped, the availability of capital is just so limited that the cost of capital will go up. People who have cash will put a price on it. Anyone who has recently raised new funds is now in pretty good shape but, of course, fund sizes are limited and if the LPs and banks don't have cash available then how long will you need to live with your pot of money today? That's the big question for anyone who has cash. What's the price that you demand? That will go up quite dramatically. You already see this happening very strongly in the US where senior debt is becoming incredibly expensive.

Menzel: We are seeing some positive shifts in capital. We've been talking to one of the vast macro funds, who can now get double digit returns on senior loans with moderate leverage, which is obviously very

Edwards: It won't be as simple as economics, liquidity and capital – there's got to be a behavioural shift. The mass delusion of the last two or three years – that because there were five others doing the same thing it was therefore a brilliant proposition – is gone. The bank has to put in structures that work for the business. If it's a growth business, then fund the working capital growth. If there are asset heavy balance sheets, then make sure the assets are funded. Don't fund a growth business with an aggressive five-year, straight-line amortising debt structure so that it's actually growing into a problem saying: "Don't worry – we'll refinance in 18 months time." Every time you saw an IM the back page always included: "It'll be a secondary or a trade exit and we'll do a refinancing in year two or year three." Therefore, the prior 97 pages had no bearing whatsoever because the last page was perceived to be the truism. I hope as a financial community we actually just get smarter and ask the "what happens if?" questions, the behavioural shift has to be the creation of sustainable shareholder value not behaviour blinded by a one off bonus and I hope that FDs are encouraged to resist the pressures to put overly stretching debt structures in place but insist that the debt structures protect the business viability and opportunities.

Nuijens: There are many people in this market who have to continue to prove themselves and have to do deals to generate fee income. However, many pots of money are held with people who are saying: "Actually, I don't need to invest right now – I'd rather wait for three months, six months, nine months or as long as it takes to feel where the market is heading; where the economy is heading." So they will wait for better times which will slow down deal activity. ■