

VIEWPOINT

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WHY THIS MATTERS:

- Deal professionals need to understand the factors pushing LBO valuations upward, and assess the risks of transactions priced at high multiples to earnings going forward.
- A collapse in LBO financing would undoubtedly affect other markets, including investment and non-investment grade debt, and public and private equity.
- Understanding how the current liquidity boom started — and why it may end — can help deal makers and entrepreneurs determine the timing and structure of future financings.

LBO DEBT IS ON THE RISE: EFFICIENT MARKET OR MARKET BUBBLE?

By Jamie Grant and Enrique Shadah

Speaking in Chicago on May 21st, Federal Reserve Chairman Ben Bernanke signaled that he is concerned with the current state of the debt markets with respect to LBO financing. While his comments may not quite correlate to Alan Greenspan's "irrational exuberance" remark in 1996, industry insiders have begun to acknowledge that the current trend of higher debt multiples and weaker loan covenants is not sustainable. At the same time, many in the private equity community observe that corporate lending has simply matured to a point where there is now an efficient secondary market for all manner of credit risk, and that the incredible liquidity in the market comes from that efficiency.

So which is it? Have buy-out firms and lenders discounted risk to the degree that they've created a self-perpetuating bubble, or has the secondary market for corporate loans become so efficient that these obligations can be discounted and traded like bonds? Either way, it is certainly worth considering the possible scenarios for what happens when the cycle turns down, which it inevitably will.

In this month's *Viewpoint*, we'll look at the factors that have contributed to the LBO surge, the current state of corporate finance, and how both the primary market and secondary market for debt instruments have evolved and matured to provide more favorable terms and attractive interest rates for buy-outs and traditional debt financing alike. Then we'll discuss some likely outcomes for the current environment, similarities to the subprime debacle, and what may happen to the capital markets if LBO financing is in fact a bubble that ultimately bursts.

"A PROLIFERATION OF PRIVATE CAPITAL HAS RESULTED IN UNPRECEDENTED LIQUIDITY, WHICH HAS IN TURN CREATED A MARKET WHERE DEBT-TO-EQUITY RATIOS ARE ON THE RISE AT THE SAME TIME THAT COMMERCIAL LOAN DEFAULT RATES HAVE REACHED RECORD LOWS."

that had been priced at a discount by the original lender. For example, a lender might offer 10 loans worth \$100 million at face value to a hedge fund for \$60 million. If the hedge fund could collect

more than 60 cents on the dollar, it would earn a return. If its purchase was also leveraged, the return could be substantial. The high returns from such investments in distressed debt securities has resulted in a mature secondary market which has discounted the inherent risk to the point where these same distressed loans now trade at 90 cents on the dollar and up.

A RECENT HISTORY OF THE COMMERCIAL DEBT MARKET

It's no secret that private capital has flooded into all areas of commercial finance over the last several years, with a dramatic increase in non-bank sources of financing — including non-depository credit institutions, business development companies (BDCs), hedge funds and private equity firms. Even troubled companies have ready access to debt capital these days, with hedge funds and other players standing ready to refinance businesses that in other market climates would have been forced into bankruptcy. This proliferation of private capital has resulted in unprecedented liquidity, which has in turn created a market where debt-to-equity ratios are on the rise at the same time that commercial loan default rates have reached record lows.

Not long ago — perhaps as recently as the last decade — middle-market businesses had few options when seeking debt financing. A closely-held company might approach three to four banks and receive nearly identical term sheets from each — rates, covenants and fees would all be fairly consistent. The difference might come down to twenty five basis points. Few lenders were willing to step too far out on a limb.

That began to change in the late 1990s and early 2000s, as new players emerged in the market. A raft of non-depository credit institutions such as GMAC and GE Capital began moving into commercial finance and leveraged buy-out financing. Business development firms, which are structured like real estate investment trusts but invest in private businesses instead of real estate, raised money in the public markets and began lending to companies, while themselves using leverage ratios of 4-to-1 or more, supported by a "warehouse" line of credit from a major bank. These new market players are not regulated like banks, so they can afford to be more aggressive in their terms and rate offerings. As banks began competing against these new players, borrowing rates fell and covenants became more permissive.

In recent years, another type of participant has emerged: hedge funds. Hedge funds first entered the market by acquiring distressed debt (packages of failed or non-performing loans)

The result of these new financing options was that fewer and fewer distressed companies were allowed to fail; they could simply refinance their debt with another lender. The threat of bankruptcy had always provided discipline in the market, but as this threat has receded, so has the lenders' level of caution. New "covenant-lite" loans began to emerge, removing some of the safeguards that allowed lenders to liquidate troubled positions. And, betting that there would always be another financier to buy a failed deal, investors began to discount the risks of investing in distressed companies. So default rates fell, rate spreads contracted, and liquidity flooded into the market.

IMPACT ON THE M&A MARKET

Armed with ever growing pools of cash, private equity firms have begun to compete head-to-head with strategic acquirers, accounting for 33.6% of total U.S. deals by volume through the first six months of 2007. The high level of buy-out activity has driven up the value of private and public companies alike. Consider that in 2002 the aggregate value of all U.S. leveraged buy-out transactions was \$58.9 billion. In 2006, LBO aggregate value was \$395.6 billion, a nearly seven-fold increase in just five years. And through June 15, 2007,

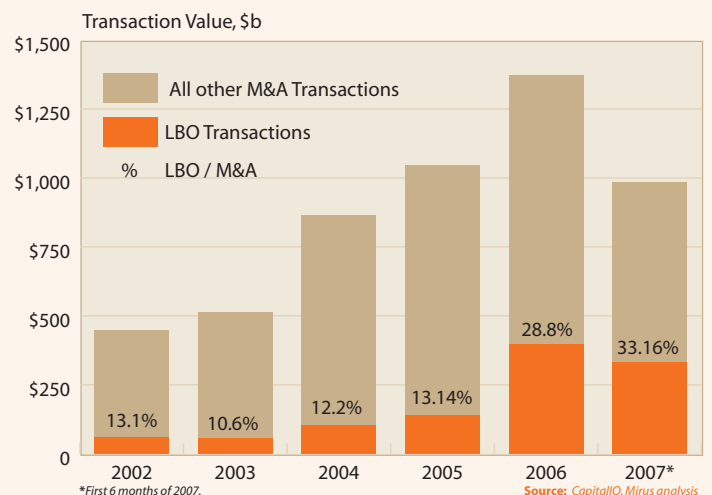


EXHIBIT 1: AGGREGATE VALUE OF LBOs RELATIVE TO TOTAL M&A 2002-2007 (2007 represents YTD through June 15th)

year-to-date LBO activity has already exceeded \$331.5 billion (according to CapitalIQ). At the same time, valuations paid by private equity groups have steadily increased, closing the gap with strategic acquirers (as Exhibit 2 demonstrates).

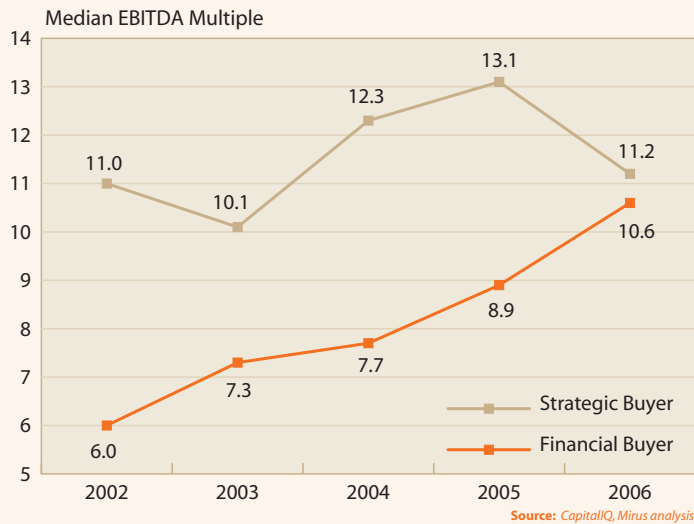


EXHIBIT 2: VALUATIONS PAID BY FINANCIAL AND STRATEGIC BUYERS ARE CONVERGING

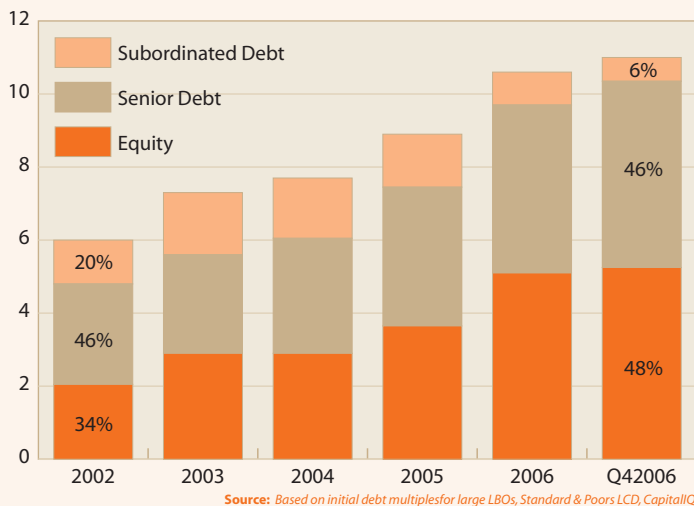


EXHIBIT 3: EXPANSION IN SENIOR DEBT MULTIPLES HAS DRIVEN LBO VALUATIONS

With LBOs accounting for 28.8% of all M&A transaction volume in 2006 and a third of all M&A volume so far this year, the combination of more competition for deals and a growing appetite among lenders to finance these transactions has resulted in higher valuations. Exhibit 3 illustrates the impact that growing debt multiples have had on overall buy-out valuations. According to Standard & Poors and CapitalIQ, total debt multiples on leveraged buyouts averaged 3.8x EBITDA in 2002, resulting in LBO multiples of just under 6x EBITDA overall. By the fourth quarter of 2006, debt multiples of more than 5.5x EBITDA had driven LBO valuations up to 10.6x EBITDA.

INCREASING CONCERNS AMONG REGULATORS AND MARKET PLAYERS

Despite a climate of increased risk, with debt multiples above 5x EBITDA, interest rate spreads have paradoxically narrowed. In the first quarter of 2007, LBO loans were closed at an average premium of less than 250 basis points over LIBOR, down from nearly 350 basis points in 2004 (as shown in Exhibit 4). As a consequence, lenders are taking on more risk for smaller returns.

Recently, the Federal Reserve has begun to use its power of moral suasion to influence buy-out groups and their lenders, pointing to the high debt multiples and increased risk in leveraged transactions. "There are some significant risks associated with the financing of private equity, including bridge loans, [and] we are looking at that," said Federal Reserve Chairman Ben Bernanke at a Chicago conference on May 21.¹ Less than a week earlier, Timothy Geithner, president of the New York Fed, made similar comments².

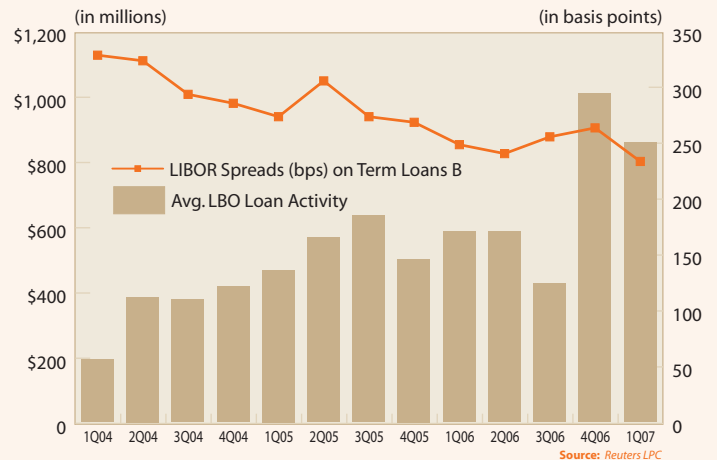


EXHIBIT 4: U.S. LBO LOAN ACTIVITY

The Federal Reserve has, as yet, made no effort to rein in LBO lending, however, and activity continues to build. Currently, even some industry pundits are skeptical that the good times will continue. "This economy is not going to get better, especially for manufacturing and industrial companies," says Michael Psaros, managing partner at KPS Capital Partners, in the same May 22 Wall Street Journal article. "We are selling everything that isn't nailed to the floor at prices that are between stunning and inconceivable."

COVENANT-LITE LOANS EXACERBATE CONCERNS

Covenant-Lite loans, or loans without default triggers tied to financial performance and other variables, have soared in the last year. As the lending environment becomes more competitive, lenders have increasingly agreed to forego

¹ Wall Street Journal, May 22.

² Ibid.

many of their time-honored protections, such as interest coverage and asset coverage covenants, assuming that another lender will be available to refinance a troubled deal.

Borrowers have benefited from less restrictive loan covenants and a benign interest rate environment, which ultimately helps targets pay for the increasing amounts of debt on their balance sheets. Yet covenants have traditionally provided an early warning system for lenders which in turn inspired discipline among borrowers. Without them, lenders are more exposed to the risk of default, and borrowers are at greater risk of becoming insolvent before the bank forces them to act.

Close to 15% of all leveraged loans in May 2007 were covenant-lite, up from virtually zero percent a year earlier. Fitch Ratings reports covenant-lite issuance of a record \$29.5 billion in the first quarter of 2007. The rash of covenant-lite loans are one reason we are seeing historically low default levels; the events that have triggered default in the past – poor financial performance, high leverage, failure to make interest and principal payments – continue to occur, but they are no longer sufficient to trigger a default. Moreover with interest rates low, even troubled companies find it easier to pay or refinance their obligations.

Low defaults, tight spreads, and easy credit – how long can this best-of-all-possible-worlds last? A number of signs point to trouble ahead.

Regulators worry that if (when) that market high yield falters, losses in bridge financing might force an exodus among the more leveraged hedge funds and BDCs – and a tightening of lending requirements among more traditional lenders like banks. Banks now reaching beyond their traditional asset-based lending practices might quickly become more cautious. Opportunities to refinance distressed loans would soon dry up given even the slightest hiccup in the economy – such as the failure of a large buy-out deal. Much like the rapid descent of the subprime mortgage lenders, banks that premised their deals on the idea that nearly any transaction could be refinanced

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might be left owning troubled companies, as the lending environment turns more conservative.

What would this mean for M&A and the capital markets?

There is no doubt that higher valuations in the M&A market have been in part predicated on easy financing. A break in the LBO debt market would almost certainly result in fewer buyers, and ultimately result in less competition and lower valuations for privately held companies.

It would also likely spread to the public markets, since a certain proportion of the run-up in small cap stocks can be attributed to LBO activity. In recent months there have been several stocks that have run-up on buy-out speculation, not because they're well managed, but because they have become weak enough to become takeover targets. By pulling the plug on the LBO market, many small stocks that have been propped up by high M&A multiples will lose favor with investors, and their share prices will suffer.

ADAPTING TO CHANGING MARKETS

In recent weeks, Mirus has observed that a growing number of market observers are urging caution. In an interview in the June 18th edition of Businessweek, Sun America and KB Home founder Eli Broad was asked to respond to a question about the glut of private equity money and its impact on the global economy.

He said, "We've had the perfect storm: low interest rates, easy credit – I've never seen banks so lenient in their lending to private equity firms for leveraged buyouts. Same thing in mortgage credit. I can't see how this can continue. We haven't seen deals of any size that have gone bust. But there will come a day of reckoning, and we're all going to sober up."

Recognizing the potential for volatility is, perhaps, the first step towards managing it. No one knows when or even whether the LBO debt market will hit a rough patch, but no savvy market player should assume that current, nearly ideal conditions will continue indefinitely.

Jamie Grant is a Partner of Mirus Capital Advisors, Inc., and heads the firm's Family Business Advisory. He may be reached at Grant@merger.com. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

Enrique Shadah is an analyst at Mirus Capital Advisors and can be reached at shadah@merger.com

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