

This article was published in a slightly different form in the October 2008 issue of *Acquisitions Monthly*

The Beginning Of Interesting Times

Stephen Phillips

White & Case LLP, London

The UK's Chancellor of the Exchequer recently stated that we face the most challenging economic conditions for 60 years. Quite why 1948 is the starting point for the comparison is another debate, but we are writing the day after America's fourth largest investment bank, Lehman Brothers, filed for Chapter 11 (and the day the US government bailed out AIG). It is no longer tenable to view the current conditions as just a temporary blip. While we can all have opinions about how severe the coming downturn will be, what is not in dispute is that the era of easily available credit is over for the time being. When economists review the period prior to the credit crunch – or to use a better name – liquidity crunch, they will depict an era of easy liquidity, which spurred the growth of complex deal making in the various financial capitals of the world. Much ink has already been spilt on the problems relating to sub-prime mortgages and acronyms such as SIVs, CDOs, and CLOs have now passed into the public's vernacular.

This article is not, however, about such financial alchemy (an appropriate metaphor, by the way, since recent events have proved again that you cannot turn base metal into gold). It will focus on

activities in the 'real economy', which are beginning to be affected by the liquidity crunch. Vast swathes of industrial and service activity were taken over by private equity firms in leveraged buyouts in recent years and the number of private equity houses expanded from 231 in 2002 to 735 last year.

According to Mergermarket, there were 449 private equity transactions in Europe in 2002. The number of such deals recorded for 2007 was 1732 and 924 have been recorded to date in 2008. Private equity funds made very good returns in the recent era of rising asset prices. For example, according to Financial News, Apax Funds have generated a net annual IRR of 38.3% over the past ten years.

In an era of easy credit terms, private equity houses were able to take over larger and larger companies; Cerberus taking over Chrysler showed that almost any deal was possible by private equity. Much of the activity moved away from the supposed modus operandi of private equity companies – taking struggling, asset-heavy companies, making them better and selling them – and shifted to secondary or even tertiary buyouts.



Stephen Phillips
Partner

The Beginning of Interesting Times

Some private equity companies would buy a company for a short period and then flip it to the next private equity group. The squeeze on costs and the operational improvements may have already been achieved by the time a tertiary buy had occurred and many of the enhanced returns were helped by better financing terms and rising asset prices. In the years leading up to the liquidity crunch the amount of equity lenders demanded to be committed in any deal was reduced over time and the financing terms improved from the borrower's perspective.

Top of the market deals also included industries that may not have been well suited for high leverage levels. In hindsight and, as an example, it is not clear that the private equity model is going to work well for estate agents, an activity prone to cyclical highs and lows. As the equity proportion in LBOs reduced more leverage was needed for any one transaction – in effect shifting much of the risk from equity houses to the creditors. Statistics on leverage multiples showed that average debt to earnings multiples of European LBOs in 2002 was 4 in 2002 and 5.9 in 2007 according to a Standard & Poor's LCD survey. The author has, however, seen total leverage multiples far exceeding these average statistics.

Another phenomenon in the pre-liquidity crunch era was for loans to be documented on a 'covenant-lite' or 'covenant loose' basis. The 'covenant-lite' model was more prevalent in the US than in Europe. The idea was to use incurrence type covenant tests frequently seen in high yield bonds rather than the more standard maintenance type covenants. Incurrence tests are only triggered when certain corporate actions such as borrowing are proposed; if the test is breached the borrower cannot proceed with the transaction but an event of default is not triggered. For maintenance financial covenants the point for bankers is that a breach acts as an early warning system. Once covenant breaches arise, borrowers are forced into an early negotiation before conditions deteriorate further. With covenant-lite deals and deals where the financial covenant tests were loose, banks may not have the same trigger point to force an early negotiation and

it is possible to imagine that private equity houses and managements may wait to the last possible moment to begin any debt restructuring discussions if a borrower is financially stressed.

Given the macroeconomic backdrop, it is our expectation that a variety of deals will come under severe pressure in the coming months and years. In a survey completed by Standard & Poor's in February 2008, 53% of the sampled companies admitted they were underperforming their base case EBITDA model. One would have to speculate that as the macroeconomic picture has deteriorated since then, the current figure is significantly higher.

For many companies in a number of industries, standing still as regards their previous earnings over the last couple of years will be a great achievement. Many LBO base case models, however, are predicated on significant earnings growth – companies were supposed to grow into their capital structure. While many lenders agreed to looser covenants at the top of the market at some point the covenants will bite and this has already resulted, in certain instances, and is likely to result over the next few years, in a number of covenants trips.

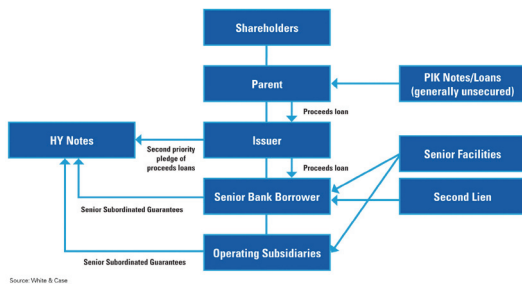
Another factor which will contribute to a rise in the default rate is refinancing risk. The withdrawal of liquidity is likely to see a number of defaults as lenders refuse to refinance on previous high earnings multiples. All these factors point to a significant and sharp increase in defaults from a very low base. Standard & Poor's LCD puts this in perspective by adding that the default rate is set to rise from below the current historical average of 1.55% to about 8% by the end of next year.

When covenants do trip the question on everyone's mind is what will happen. Many of the companies in question are good companies which generate solid earnings. For the most part these are businesses that no one will want to see collapse into value destructive insolvency processes. In Europe it is likely that lenders, sponsors and the borrower will hammer out a new capital structure with many parties taking significant financial pain. Unless private

The Beginning of Interesting Times

equity houses agree to commit very significant equity injections, lenders are likely to want to own the borrower in return for any debt write-down.

The novel element of the next wave of defaults is that any negotiation is likely to see so many stakeholders at the table. The diagram shows an illustrative capital structure which highlights the numbers of creditor groups who will have funded a leveraged buyout.



The novel element of the next wave of defaults is that any negotiation is likely to see so many stakeholders at the table. Some structures may include any combination of Payment in Kind (PIK) Notes (notes which capitalize at the end of interest periods) issued at the top of the capital structure, high yield notes slightly further down, mezzanine debt, second lien debt, and senior debt. The relationships between all the various creditors will usually be documented in an intercreditor agreement, although senior lenders in some PIK structures relied only on their structural superiority. To further complicate matters, lenders of record may have bought or sold credit default swaps, total return swaps or otherwise passed the economic risk to other stakeholders who may be difficult to identify.

Intercreditor agreements will have their limitations in a financially stressed situation. It is hard to legislate for every eventuality (and some were drafted under great pressure). For example, if two different stakeholders wish to lend fresh money to rescue a company, while it is likely that covenant structures may give many of the creditor groups a veto over additional lending to a borrower, the intercreditor agreement will not provide guidance as to which financing package the borrower must accept.

One of the most vexed questions is likely to be whether the guarantor release mechanism is likely to work in the intercreditor agreement. Most intercreditor agreements will provide that following an event of default the senior lenders are entitled to instruct the security agent to enforce the security (which is likely to be a share pledge). The security agent will want to sell shares at a holding company level and grant a release of the guarantees that junior creditors have against any of the operating companies in order for the operating companies to be sold to a new buyer free of the junior claims.

This sale may be complicated if any of the junior creditors have been asked to 'push down' their claims into the operating companies, as intercreditor agreements tend to allow junior guarantee claims to be released but do not allow for the primary debt claim of a junior creditor to be released.

We have seen other examples where the release mechanism may not achieve the desired result of a clean sale. While this may seem academic as many restructurings tend to be done on a consensual basis, the ability to enforce is the senior lenders' ultimate sanction if a deal cannot be agreed and sets the backdrop for any negotiation.

The release mechanism may not be the only problem facing senior lenders if negotiations have broken down and they want to take enforcement action. The patchwork quilt of European insolvency regimes have different rules regarding security enforcement and some of their characteristics may make security enforcement action difficult to take, either because of a moratorium that may apply on bankruptcy or draconian penalties on directors who do not file for insolvency protection at the first sign of trouble.

The next couple of years for the private equity industry and for the supporting banks in leveraged financing is going to be fascinating. Most deals will remain unscathed but our expectation is that bankers and owners will need to pay close attention to their existing portfolios and restructuring activity

The Beginning of Interesting Times

will increase dramatically. Secondary debt buyers are likely to be salivating at the prospect of being able to buy cheap debt and force a debt equity swap, although they will have to choose carefully which layer of debt to buy into, and to check very carefully the terms of the intercreditor agreement, the group structure and the potential holdout rights of other debt classes.

There is also anecdotal evidence that there will be a thriving market in the secondary equities market. According to Nyppex, the US exchange for private funds and companies, the market for 'direct secondaries' is likely to increase from \$3bn last year to \$5 bn this year. Given the statutory protection given to shareholders in most European countries, there are likely to be opportunities for extracting value for equity even above the rights of some classes of creditor.

Untested structures will be tested in the coming years and amidst the successful restructurings there will be failures, given the sheer number of competing stakeholders. The distressed investment industry is likely to be recast and the buccaneering days are over for now. Restructuring advisers, work-out bankers and distressed investors are about to embark on a journey into a new and challenging era.

Stephen Phillips is a Partner in the Financial Restructuring & Insolvency team within the London Banking and Capital Markets Group and specialises in advising banks (at senior, second-lien and mezzanine level), bondholders and steering committees on restructuring and banking matters.

The information in this article is for educational purposes only; it should not be construed as legal advice.

Copyright © 2008 White & Case LLP
