Buyouts
REUTERS
YOUR SOURCE FOR LEVERAGED AND MANAGEMENT BUYOUTS

15 December, 2008

The De-leveraged Buyout

Buyout professionals tend to downplay the role that leverage—a commodity, after all—plays in their market-beating returns during the good times. Now that we're in a downturn, they're talking even less about how it magnifies losses.

But consider this: Secondary market-maker NYPPEX projects asset write-downs of 40 percent to 80 percent for certain U.S. buyout funds in 2009. That's based on an estimated 20 percent drop in private-company valuations in the 12 months ended October 31, and an average of 60 percent debt leverage deployed on deals. If that weren't enough damage, leverage also has the insidious habit of raising the risk that such losses actually get realized.

With those realities as a backdrop, more buyout shops have been trying to de-lever their portfolio companies in recent weeks. **A. Richard Hurwitz**, vice president-communications and investors relations at **Sun Capital Partners Inc**., of Boca Raton, Fla., said that three companies out of roughly 90 in the firm's collection have been buying back debt using working capital and then retiring it.

These are good-sized companies. Each generates revenues of at least $800 million. None are performing especially poorly for Sun Capital, which intentionally buys companies that are doing worse than their peers. Two are buying high-yield debt back on the open market at about 50 cents on the dollar; the third is buying back senior loans from lenders at about the same price. In relieving their debt loads, these companies get more flexibility to deploy cash in the months ahead, and face lower risk of going into default. "We're just being more cautious, that's all," said Hurwitz, adding that buying debt at 50 cents on the dollar today is a heck of a lot cheaper than having to refinance it at par down the road.

Of course, not all portfolio companies are in a position to buy back their own debt. Those that cry out for de-leveraging—or whose creditors do—but that lack the working capital, present less appealing options for their owners. These include putting more equity in, selling off assets to pay down debt, or using their own money to directly buy back debt. Attorneys say that the third option is getting a lot more attention in recent weeks, given how cheaply loans and bonds are trading on the secondary market. **Steven M. Ellis**, a partner with Proskauer Rose LLP, said that of 15 or so buyout-backed restructurings on his plate, sponsors have acquired debt in four of them, and the topic was broached in all 15.

Debt buy-backs by buyout shops can solve problems quickly, Ellis said. Once a company runs into trouble, senior lenders tend to get a lot stingier with additional credit lines and could even start talking about such draconian measures as voluntary bankruptcy filings. Take a slug of debt off their hands and these lenders become a lot easier to work with. Buyout firms that go on to retire the debt they acquire also contribute to the company's de-leveraging. That's yet another welcome development for creditors, and a boon to the company's prospects. But buying up debt in portfolio companies also presents a number of obstacles and challenges for deal sponsors.

Junior lenders, for example, often write covenants into their credit agreements that expressly preclude equity sponsors from acquiring debt. (They don't want an equity sponsor having, say, the ability to block debt payments.) Junior lenders can be convinced to sign a waiver. But in doing so, they usually insist that buyout shops give up rights they'd otherwise enjoy as senior lenders, such as the right to vote on the waiving of defaults, or on the exercising of remedies to deal with defaults. Junior lenders may also ask that the buyout firm be subordinated to them in the event of a default. Other potential obstacles:

- Retiring debt may trigger forgiveness-of-indebtedness income that can give rise to a tax liability for a portfolio company.
- Under lender liability laws, lenders are prevented from controlling a company. And it's easy to see why: One set of creditors (say senior lenders) shouldn't be in a position to decide when another set of creditors (say suppliers) get paid.
- If they try to maintain an active role in running the company, buyout firms face the risk of having a court later re-characterize their debt as equity.
- Buyout firms may need permission from their limited partners to buy the debt, if their partnership agreements don't allow for it. Depending on the situation, they may also need to get permission to invest in the same company from two different funds.

Buyout firms know how to be creative when it comes to leveraging their portfolio companies. It looks like they're going to have to get creative again in de-leveraging them.

© Reuters Media 1992-2009. All rights reserved.