

Special Comment

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The Private Equity Advantage

Sponsored issuers in the credit crunch

Summary

During periods of illiquidity like the current credit crunch, private equity-sponsored companies have advantages over most non-sponsored firms that are experiencing distress:

- Continued access to capital from their own resources
- Longstanding relationships in the capital markets
- More efficient capital structure and potentially lower restructuring costs.

Since the severe contraction of liquidity began in the summer of 2007, private equity-sponsored companies have had considerably less access to the credit markets than they did previously, and financing has become unusually expensive. As a result, the many sponsored firms that have experienced severe financial setbacks have had to rely more heavily on either their equity owners' ability to provide capital, or on options within their lender agreements, such as PIK toggle options or equity cures, as an alternative to restructurings or potential bankruptcy filings.

We have found that many issuers backed by private equity have access to capital sources unavailable to strategic operators facing similar market constraints. Firms have proceeded with acquisitions and capital expenditures funded exclusively with capital from their sponsor shareholders, and have taken advantage of such options as equity cures to avoid the potentially expensive re-opening and repricing of credit agreements when it has become necessary to obtain covenant relief. Equity cures allow the private equity owner to contribute sufficient capital to EBITDA to prevent violation of a financial maintenance covenant. Lending agreements often have limitations on equity cures, such as clauses preventing a "cure" every quarter.

Note: This report is part of an ongoing series of special comments concerning private-equity issuers. For recent comments, see Moody's Related Research, page 5.



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We expect that companies with private-equity access will continue to tap equity cures and other sources of capital in 2009 as credit availability remains tight. But we will be watching two variables: The timing of upcoming maturities, and the willingness of private equity funds to continue providing financing without assuming leverage.

This special comment poses some hypotheses regarding outcomes for private equity-sponsored transactions. The evidence is continuing to emerge and we will issue further comments on these transactions over time.

The private equity advantage

Private equity firms' access to capital is supported by the compelling advantage of having "locked up" their investors' funds. Typically, investors provide capital for about seven years, although the range can be shorter or longer. Evidently, private equity still has remaining capital to deploy today; it is only the length of the credit crunch that may eventually test the liquidity of these firms.

Such companies as Kraton Polymers, owned by TPG Capital, and DeCrane Aerospace, owned by DLJ partners, have used the equity-cure feature of their credit agreement. Others, such as KIK Custom Products, owned by Caxton-Iseman, received a direct equity injection. It is likely we will see more such moves in 2009.¹

Rating implications

In cases where we expect the sponsor firm to step in if covenant compliance is at risk (for example, using the equity cure), the likelihood of default diminishes — and as a result the Probability of Default rating (PDR) may not be lowered. While a speculative-grade liquidity (SGL) rating measures liquidity in the absence of access to the capital markets, the PDR incorporates our expectations of lender and shareholder behavior. Similarly, if we think that a distressed exchange is more likely than a public filing and/or liquidation, the long term Corporate Family rating (CFR) may be higher than it might be otherwise. The higher CFR rating is driven by the expectation of a higher recovery, given that the firm will likely remain a going concern and can avoid the time and money associated with a bankruptcy filing.

Current trends

Private equity firms have been willing to provide considerable capital to support the firms they sponsor this year, in an environment of very limited liquidity. In fact, in the current environment, an equity injection from the sponsor firm may provide a better long-term return to the sponsor than renegotiating a credit facility with lenders, reversing the trend of using leverage to enhance returns

Thus far this year, private equity firms that believe their sponsored companies will comply with their covenants by a modest margin generally appear to be assuming the potential covenant default risk, rather than subjecting their companies to the amendment process. One credit agreement measure that has proved fortuitous is the equity cure, which, in general, has provided a relatively low-cost means for preventing near-term defaults. Several sponsors have used the equity-cure option to prevent an issuer default and several more have stated they would if it proved necessary. Another private equity friendly measure has been the PIK toggle feature of loans and bonds, which provides additional liquidity for distressed and non-distressed credits alike by allowing them to meet interest obligations by issuing more debt rather than by paying cash.²

Where recovery of the equity investment is deemed unlikely, sponsor firms are clearly willing to sacrifice their initial investments, as evidenced by the bankruptcy filings of Pierre Foods, owned by Madison Dearborn Partners, and Linens 'N Things, owned by a consortium led by Apollo Management. We do not expect that private equity firms would continue to invest in businesses not considered salvageable. We note that given the current economic environment, distressed opportunities are proliferating and increasingly private equity firms

¹ A possible exception: Sun Products, owned by Vestar Capital, was able to raise \$625 million in mezzanine-level debt in August 2008 — along with an additional 13% capital contribution from the sponsor (\$360 million in common equity) — in order to fund its acquisition of Unilever N.V.'s North American laundry assets.

² See October 2008 special comment, "Use of PIK Interest Option Can Be Sign of Credit Stress."

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will have to decide whether their next dollar is better spent in a new distressed asset or in one they already own.

Private equity-sponsored firms and bankruptcy

In addition to having unusual access to capital in an illiquid market, the private equity firms' leveraged buyouts (LBOs) may have lower distress and bankruptcy costs than public firms, since LBOs have fewer stakeholders and can generally act quickly when facing a crisis. Moreover, restructurings should potentially be more efficient, since the majority of the debt is concentrated in the syndicated loan market rather than with public debt holders. This is less likely to hold true for the largest LBOs, financed with complex capital structures at the peak of the boom.

So not only can LBOs turn more easily to their financial sponsors for additional capital, but the private equity owners usually have long-term relationships with lenders that can facilitate re-financing and renegotiation where that is optimal. Similarly, we expect that private equity-sponsored transactions would be more likely to achieve a private restructuring rather than the more expensive public filing. Given the current difficulties in securing debtor-in-possession financing, public bankruptcy filings may become even more destructive.

Thus our more general expectation for lower firm-wide recoveries over the near term³ may be somewhat offset for private equity-sponsored issuers by the potential for more efficient restructurings. The recent increase in distressed exchanges among all defaults supports the notion of more efficient restructurings. Distressed exchanges have risen from 10% to 15% of total defaults historically to about 20% in 2008. This may also be driven by the fact that, while the private equity-sponsored issuers of recent years were often operationally sound, valuations were too high. The firms' underperformance may have been driven by too much leverage, rather than the need to restructure contracts or fix business segments.⁴

The expense associated with distress varies and tends to be much higher amid operational challenges. Financial distress, such as excessive leverage, tends to be easier to address, which should help support firm-wide recoveries.

Private equity trends: Correlation with credit markets

In general, the high leverage typical of a private equity-sponsored transaction is not primarily associated with a particular sector, but with return objectives. Not surprisingly, LBO sponsors will pay higher prices and take on more debt when debt financing is cheap (that is, when the debt markets are overly generous and possibly misprice risk). Research has shown that good deals are more often done in poor credit markets, while bad deals are more likely in overly generous credit markets.

The first LBO boom, during the 1980s, was led by the junk bond market, and the most recent boom by the syndicated loan market. Given the excess liquidity from roughly 2005-2007, lenders should expect that transactions from that period were often executed at multiples that relied on very aggressive growth projections, albeit with very attractive borrowing costs and flexible terms. Hence any deterioration in operating performance (as opposed to the almost universally "projected" improvement) implies erosion in equity.

Moreover, based on current refinancing rates, a lender's equity cushion will diminish further if an issuer has to refinance. In the many cases we have observed in 2008, private equity firms have committed additional equity rather than allow their portfolio companies to become financially distressed, particularly by having to open a credit agreement to the costs of an amendment and repricing.

Our analytical concerns to date have mostly focused on covenant compliance, because so many transactions do not have upcoming maturities in the near term. We believe refinancings will be far more expensive to secure. Moreover, private equity capital may not outlast the credit crunch. We note, however, that according to UBS and Thomson Financial, private equity has raised close to \$20 billion exclusively for distressed debt investing.

³ See September 2008 special comment, "Heavy Bank Loan Issuance May Cut Recoveries as U.S. Corporate Defaults Rise."

⁴ There are certain notable exceptions, such as Cerberus' acquisition of Chrysler, which faces significant operational challenges.

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Conclusion

In an environment of very limited liquidity, issuers owned by private equity firms have the advantage of reasonable access to capital for acquisitions – and often, equity cures – while distressed strategic firms need to seek outside investors to contribute liquidity. It is not certain how the private equity market will respond to upcoming maturities or how long private equity firms will be able to fund capital needs without the benefits of incremental leverage.

Unfortunately, if history provides a reasonable forecast, the 2005-2007 vintage private equity transactions are likely to underperform, given the absolute abundance of liquidity when they were executed. By contrast, transactions executed today should be more successful, because leverage and acquisition multiples are likely to be much lower. Historical evidence suggests that investments made during economic recessions usually outperform, although recoveries on existing transactions are generally lower.

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Moody's Related Research

Special Comments

- Large service-sector LBOs, December 2008 (113290)
- Private Equity: Tracking the Largest Sponsors, February 2008 (104486)
- Rating Private Equity Transactions, July 2007 (103683)
- Default and Migration Rates for Private Equity-Sponsored Issuers, November 2006 (100799)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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