

## Research Report: Buying power

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Private Equity is on the increase both globally and from a European perspective, which is the basis of this report. This research report from Demica, highlights the increasing role of securitization in European Private Equity.

## Key findings

- The recent upsurge in interest for Leveraged Buyouts (LBOs) by Private Equity (PE) houses in Europe has created a community of corporations under particular financial pressure.
- The credit rating assigned to these corporates will usually be sub-investment grade precisely because of their increased debt burden (leverage).
- Financial sponsors are therefore increasingly turning to alternative sources of finance such as asset based lending and receivables financing.
- A significant proportion (11.9% of deals) are looking to receivables (invoices outstanding) securitization as a means of raising higher-rated, lower cost, asset-backed finance from the capital markets. That proportion is expected to rise to 16.3% by the end of 2006.
- This represents growth in the use of receivables securitization and sale of receivables in European post LBO finance of 37% in two years.
- 62% of European PE professionals feel there is an increasing focus on the terms of 'carve out' provisions in financing agreements, in order to provide greater flexibility to change to alternative financing structures following a buyout.

## Introduction

PE activity is on the increase – both globally and from a European perspective which is the basis of this report. Following a low point in 2003 (compared to the frenzy of activity around the millennium) we are now seeing a steady rise in leveraged buyouts and – just as importantly – successful exits (witness Celanese, Eircom and Pacific Brands). According to Dealogic, “Unprecedented liquidity in the debt markets, large capital raisings by buy-out groups, and a rich source of deals at a time when corporate acquirers are scarce have fuelled the sector’s growth.”<sup>1</sup> Goldman Sachs’ financial sponsors group has forecast a ‘vibrant’ year for PE in 2005.

In 2004, PE accounted for 15% of Global M&A deal value reaching an all time high of \$294.4 billion, a 60% increase on 2003, according to KPMG<sup>2</sup>. In Europe, PE is up 25% compared to 2003 with deals worth \$147 billion, representing 21% of M&A deal value. In Germany, where overall M&A activity is generally flat, financial sponsors accounted for 37% of deal making rising from 28% the previous year. Activity in France and the Netherlands increased notably on the back of large retail deals. In fact, France became the third most active country in 2004 rising from sixth in 2003, according to Dealogic’s research. Volume increased 108% with \$133.8 billion in 2004 compared to \$64.3 billion the previous year.

However, there is also some sentiment in the market that an imbalance has emerged between sponsors demand and the volume of quality targets. Despite the fact that the number of quality opportunities has grown, this is viewed to have been outstripped by demand for high yield investments. Deloitte has been quoted as saying “[Sponsors] expect the average holding period for investments made in 2004 to be four to five years. The usual duration of a buy-out investment is 3-4 years, so the expected lengthening of holding periods may reflect the log-jam of investments awaiting realisation.

The sentiment could also suggest that [sponsors] may require more time to create value in their companies...”

In our view, the pressure of demand for high yield opportunities will only increase in 2005. This reflects the general demand trend in this area. However, for issuers, this pressure is creating a problem. According to the Financial Times, “High-yield bonds are those rated Ba1 or below by Moody’s Investors Service, or Double B plus or lower by Standard & Poor’s and Fitch Ratings, its rival credit rating agencies. A higher probability of default means issuers must offer a higher yield, relative to borrowers rated as investment grade. Over the past two years, high-yield bonds have been among the best-performing fixed income asset classes.

High-yield bond prices have rallied, sending yields down. The yield spread - the premium over government bonds that investors demand to own corporate bonds - has tightened significantly. Two years ago the aggregate yield spread on bonds rated as speculative was 13 percentage points in Europe and 11 percentage points in the US, whilst today, the aggregate has dropped to below 4 percentage points in both.”

Debt burden is a growing issue for LBO companies. KPMG<sup>2</sup> has remarked on “...concerns about a credit bubble in parts of the PE sector. Multiples of debt rose markedly over the year, in some cases reaching six or seven times earnings before interest, tax, depreciation and amortisation.” A 2004 research report from Demica<sup>3</sup> examined whether financial pressure on European companies is currently decreasing in line with positive economic indicators in Europe, or whether corporate financial pressure is actually increasing despite an upturn in some parts of the EU. The picture that emerges from the research tells a story of polarisation. Financial stress has increased for all rated companies in Europe. However, the increase has been absolutely marginal for A rated companies (3%),

substantial for B rated companies (36%), and punishing for sub-investment grade companies (49%). The sound appear to be getting sounder, but the highly indebted (by definition LBOs), with some notable exceptions, are in danger of failing. This highlights the importance and urgency for sub-investment grade companies – many of which are post-LBO corporates – to reduce their weighted average cost of capital.

From an economic view point, further company difficulties could potentially dent the confidence of the current recovery, certainly in continental Europe, and could potentially hinder progress in strong economies such as the UK. According to the annual review of European credit trends by Standard & Poor's Ratings Services, credit risk among European companies is starting to build up again and prospects for further improvements in credit ratings in 2005 are limited<sup>4</sup>.

## Enter Securitization

In order to control the level of yield that issuers have to offer the market, thereby controlling interest cost and/or making higher levels of working capital available to develop value in buy-out companies, more and more PE sponsors are turning to securitization.

With the prevailing economic climate as it is and the continuing surge in LBO activity, it is likely that in 2005, invoice securitization will continue to gain ground as a mainstream corporate financing tool in Europe and is likely to see substantial continued take-up amongst PE houses.

Over the last few years, securitization in the PE markets has mainly focused on CFOs (Collateralised Fund Obligations). In other words, the asset of the acquired company or companies is transferred to an SPV and then issued as rated (senior) and unrated (subordinated) notes to third party investors. However, this is a complicated process, especially since the assets will not have intrinsically reliable cash flows with which to

service the notes. As recently remarked by Deutsche Bank, "Historically PE interests were not conducive to securitization because of their unpredictable cash flows and volatility associated with their market value. PE professionals have therefore turned their attention to invoice debt securitization – post LBO – in the individual companies that they have bought out."

A number of transactions for post-LBO corporates have been conducted in 2004, with PE buyers increasingly focusing on invoice securitization to raise low-cost finance from the capital markets as a means of freeing up development capital. Companies need to have the right profile to qualify for these transactions – namely, a high quality receivables portfolio of at least €200m in size, spread across number of jurisdictions – but the positives incurred are proving too beneficial for PE sponsors to overlook. Funding margins of up to 100 basis points under the cost of the Senior A debt are typically achievable.

The reduction in amortisation pressure resulting from invoice securitization transactions allows much needed capital to be freed. Additionally, lower margins can improve debt service coverage for other financiers. PE houses see securitization as an opportunity to release working capital which can reduce the burden of costly debt and subsequently be invested in marketing, product development, channel development, sales incentives, and other growth initiatives. This enables the PE firm to grow the acquired company more rapidly, reduce the period it takes to divest the company and realise the return on investment for its investors. Furthermore, the typical length of an invoice securitization deal of 5 years is often an excellent fit with the exit strategy of many private equity houses, as we have noted above. If exit periods are lengthening, then the cost of servicing capital has to be reduced in order to re-balance the value creation model. In the best cases, lower funding costs (achieved by securitising the invoice book) for servicing at least a portion of individual company debt makes more funds available to accelerate company growth.

Critically, and unlike CFOs, the invoice securitization process isolates the asset pool from the credit rating of the issuer. The legal separation of a securitised invoice pool from the issuing company has the advantage of releasing that debt-asset from the millstone of the company's credit rating.

From the investor's point of view, the invoice debt securitization process offers not one, but a number of investment opportunities. A number of differently rated (and therefore differently priced) tranches will be issued depending on the default risk profile of the tranche.

## Research Findings

In order to validate and understand the precise pressures felt by private equity houses in post LBO finance restructuring, Demica commissioned a research study amongst experts in the top 40 European PE players. The research, conducted during November and December 2004, aimed to quantify the role of securitization in post LBO financing. It is believed by the authors of this report that this is the first time such an exercise has been conducted.

The first part of the research focused on the cost of leveraged finance. The majority of respondents (57%) felt that leveraged finance would become more expensive over the next two years. 29% felt that leveraged finance interest costs would remain stable, while only 14% thought it would reduce. Clearly, the consensus view is that LBOs would become more costly to finance. If we combine this with the earlier prediction from Deloitte about lengthening exit periods, it would appear that there is a growing need for flexible restructuring after an LBO, whether to reduce debt servicing burden, or to extend available working capital, or both.

This pressure was corroborated by our second finding – that 67% of respondents feel there is an increasing focus

on the terms of 'carve out' provisions in financing agreements, in order to provide greater flexibility to change to alternative financing structures following a buyout.

But what part is securitization specifically playing in the search for post LBO alternatives? An increasingly important one, according to the European PE community. A convincing 62% of our survey respondents said that they believed the role of securitization in providing alternative sources of liquidity, and its impact on amortisation/repayment schedules, was becoming more important. To put this in context, they estimated the proportion of LBO structures currently using securitization to be 11.9%, with a rise to 16.3% likely by the end of 2006. This represents a growth rate of 37% in post LBO securitization over the next two years.

## Summary

In conclusion, this research exercise places important key metrics on the role being played by securitization in managing debt service burden and working capital liquidity following a leveraged buyout. The majority of PE organisations are evidently conversant with securitization and the benefits it can offer, to the extent that they view it as a strong growth area. Although there is a natural lid on the proportion of leveraged corporate finance that can be raised through securitization, we can conclude that its potential is by no means yet fully explored. We can expect to see strong growth and activity to the end of the decade and beyond.

## Methodology

The methodology deployed for this study embraced both primary and secondary market research and included telephone and email interviews. The survey period ran from November to December 2004 and was carried out by MarketingUK.

- Primary research was conducted amongst the 40 European top PE companies in order to ascertain the following:
  - Proportion of deals that employ securitization post buyout, today and in two years time
  - Level of pressure for additional flexibility in 'carve out' provisions
  - Trends in the cost of post LBO finance
  - Change in importance of securitization and asset based lending financing after a buyout

### **Third party research sources included:**

- The International Securitisation Forum
- AltAssets
- Mayer, Brown, Rowe and Maw
- AMR Research
- KPMG
- PricewaterhouseCoopers
- TowerGroup
- Dealogic
- JC Rathbone
- Debevoise & Plimpton
- Deloitte Touche Tohmatsu
- Bloomberg
- Standard and Poors
- Moodys

## Appendix 1 – The securitization market as a whole

The securitization market has shown great growth in 2004. Statistics from the European Securitisation Forum published in October indicated that European securitized issuance is increasing at record pace, to €179.2 bn through Q3 2004, up 33% from the previous year. Earlier in 2004, Demica published a research report entitled “The New Voice of the Invoice” which confirmed that securitization is now past the ‘pioneer’ stage and is becoming accepted as a mainstream financing method and experiencing solid growth. 19% of top European companies stated that they have securitised assets within their company.

Overwhelmingly, the first choice was trade receivables (invoices) securitization (66%), with future revenue streams (34%) and loans (31%) trailing some distance behind.

<sup>1</sup> Financial Times, Private equity deals are close to \$300 billion for year, 22 December 2004.

<sup>2</sup> KPMG, 2004: First hard evidence of M&A recovery, 15 December 2004.

<sup>3</sup> Demica, The Rich get Richer, October 2004.

<sup>4</sup> Standard and Poors, Outlook for European Credit Quality in 2005 Constrained by Weak Fundamentals, December 2004.

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