Sponsors' Role in Leveraged Debt Financings

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Preferred Characteristics of LBO Sponsor/ Issuer Relationships

- Sponsor has a track record of providing economic and operational assistance following the initial investment.
- Sponsor's investment horizon and exit strategy is consistent with the company's.
- Sponsor group has successfully completed or exited investments in the same industry as the company.
- Structure provides sufficient equity to account for seasonal and industry cyclicality.
- Sponsor has substantial cash invested in relation to its voting ownership position.

Summary

Record levels of equity and debt issuance in the high-yield market are significantly influencing capitalization structures and, in some cases, altering the creditworthiness of companies that have undergone leveraged buyouts (LBOs), recapitalizations, and other change-of-control situations. A much overlooked element of the credit profile of debt issuers in this market segment is the role of the private equity groups that often engineer these transactions. When rating bank loans of issuers that have undergone or are contemplating leveraged buyouts, Fitch targets the financial sponsor's orientation and decision-making criteria, track record of providing post-investment economic or qualitative support, and relevant expertise to determine the sponsor's effect on the issuer's ability to service its debt. In addition, Fitch focuses on the type of transaction and the debt financing structure.

Market Overview

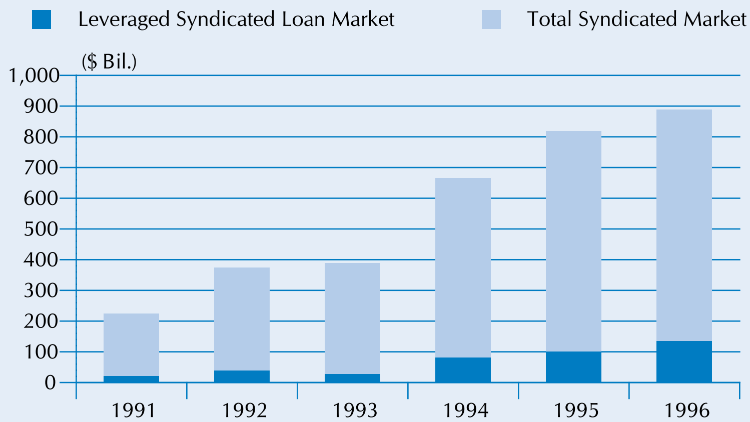
Competition among banks and other financial institutions for loans has intensified to the point where London Interbank Offered Rate (LIBOR) spreads on leveraged loans have reached a mere 139–225 basis points, a three-year low, according to the LPC Gold Sheet's broadly syndicated loan grid. Loan syndications, which amounted to more than $888 billion in 1996, have risen at a 30.5% compounded annual growth rate (CAGR) over the past five years, driven largely by 22% growth in refinancing activity and a 38% CAGR in leveraged lending.

A primary factor contributing to the pace of high-yield debt origination has been the formation and expansion of private equity funds earmarked for leveraged buyouts. LBO fundraising approximated $22.8 billion in 1996. This represented an increase of 20% from 1995 levels, which many market participants had viewed as unsustainably high. This momentum carried over into the first half of 1997, when 49 new funds, constituting $16 billion, were closed.

Due to the growing supply of funds, an increasing percentage of the LBO market can be characterized as an "auction" process, in which the highest bid generally prevails. Competition among private equity firms for a finite number of buyout transactions has led many market participants to ask whether there is too much money chasing too few deals. Additionally, the percentage of equity supporting buyouts has declined.

These trends have increased the level of indebtedness. To mitigate the dilution caused by higher purchase prices on expected equity returns, these groups have raised the level of debt financing to leverage their investments. Increasingly, LBO debt exceeds 6.0 times (x) earnings before interest, taxes, depreciation, and amortization (EBITDA) and 80% of total capitalization, versus much lower historical levels.

Growth of Syndicated Loan Market



Types of Leveraged Transactions

The nature of a leveraged transaction (i.e. friendly or hostile, simple recapitalization or change of control, auction or private sale) can have as much effect on the likelihood of default as the issuer's creditworthiness and the strength of the financial sponsor. Sponsors play a large role in defining the capital structures of most leveraged debt placements. Thus, a review of the final structure often reveals a great deal about the sponsor's underlying motivations and likely future behavior.

The nature of the transaction has several implications. For example, there is a considerable distinction between buyouts in which the sponsor acquires a controlling ownership interest with a large cash payment to existing management's ownership control and involve a minimal cashout. It is critical in the former structure that the sponsor has the ability to recruit successor management or structure strong incentive compensation arrangements. Fitch has noted that equity sponsors will more likely devise incentive programs that provide for management succession. Additionally, sponsors with longer track records tend to be more successful in avoiding auctions due to the depth of their professional contact base and the perceived certainty of closure they offer to the buyout process. This ability to avoid auctions often serves to lower buyout purchase prices, which, in turn, reduce leverage.

In assessing the structure of an LBO, of paramount importance is the transaction's effect on financial leverage (measured as total debt to total capitalization and total debt to EBITDA), at closing and over the term of the debt Fitch has been requested to rate. Fitch considers how the sponsor has tailored the capital structure to account for the inherent seasonality, cyclicality, or volatility of the business or to satisfy growth or working capital requirements. In the case of sponsors pursuing growth-via-acquisition strategies, for example, higher initial equity levels or formal provisions for equity replenishment may be required to support future growth. If this is not in place, the company is likely to end up far more leveraged than it was at the buyout date.

Sponsor Background/ Track Record

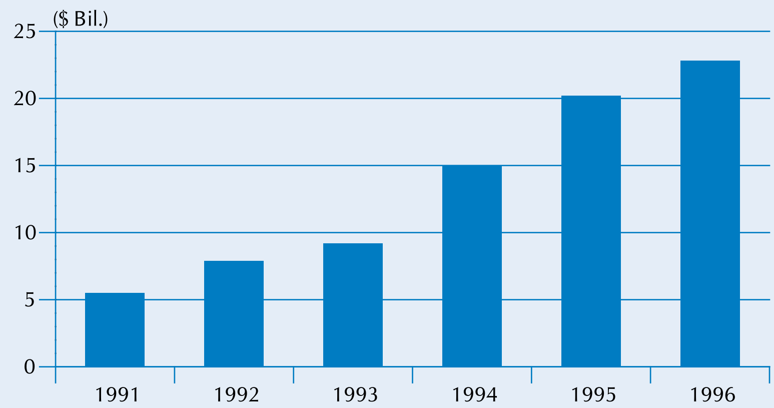
The record of the financial backer of a leveraged debt issuer can help determine whether the involvement of a certain sponsor benefits the credit profile. Fitch considers the history of a sponsor's behavior with regard to previous transactions to determine whether the sponsor has been a source of initial equity or a resource to be relied on for shepherding the company's development after the investment. This analysis is directed at understanding whether the sponsor is likely to provide financial or technical assistance following the closure of its buyouts.

Arguably the most relevant aspect of the sponsor's background is how long it has been established and the number of transactions it has completed. Sponsors that have successfully completed and exited several transactions with industry or other characteristics similar in nature to the subject transaction are viewed most favorably. In the case of equity sponsor groups that have recently been formed, Fitch focuses on the track record of the group's principals and the depth of its analytical team.

The background of the sponsor's key decision makers and professionals (i.e. financial, investment banking, lending, or operational) affects the type of buyout they are best suited to support. Fitch examines whether the decision makers have specialized industry knowledge, turnaround expertise, or other unique, value-added capabilities that will be useful to the issuer after the date of investment. Fitch has observed, for example that firms employing acquisition-driven growth strategies often benefit from association with sponsors having a financial orientation, given the level of financial re-engineering required after closing. On the other hand, businesses with significant management turnover or that need product line repositioning are usually better served by sponsors employing professionals from operational backgrounds.

When evaluating the performance of an LBO equity investor, Fitch considers whether the firm has experienced sig-

Leverage Buyout Fundraising



nificant turnover in personnel, especially at the partner level. Lack of continuity at the senior level can often serve as a red flag that the investment firm is either not unified or perceived as unsuccessful by its insiders. If partners or professionals constituting too large a percentage of the firm have departed, extrapolating the firm's historical performance into future expectations may not be possible. In such cases, the sponsor's involvement is, at best, considered a neutral credit factor.

Certain sponsor groups have developed strong reputations for their capabilities with regard to pre-investment due diligence and post-investment support. Experienced sponsors are often skilled in identifying competent management teams, perhaps the most important element of evaluating an LBO candidate's profile. During this process, they are often able to correct weaknesses in senior or middle management by tapping their network of business and consulting contacts.

Sponsors can also provide post-closing financial support directly (through additional equity investment) or indirectly (by negotiating with existing banks for additional financing or the restructuring of certain terms and conditions). This is especially important for cyclical or growth companies, as is the depth of the sponsor's capital resources.

Sponsor Orientation/ Decision-Making Criteria

Established financial sponsors have identifiable investment preferences and behavioral patterns. Many limit themselves to investments within specified industries, and a large percentage target investment candidates within a defined size range (measured by revenue or market valuation). By understanding a sponsor's culture, Fitch is better able to gauge the sponsor's motivation and rationale for supporting a given transaction and the level of ongoing support that can be expected.

Especially telling is whether the sponsor typically employs an active or passive investment strategy. In most cases, the post-closing support of a sponsor will be in the form of financial advisory services, including the arrangement of additional capital and advice regarding add-on acquisitions or restructurings.

Fitch considers whether the sponsor has a short- or long-term investment horizon and whether it participates in auctions when making buyout offers. These two areas directly affect the compatibility of the equity sponsor and banks lending to the same company in that they influence the level of leverage and tenor of a given structure. The exit strategy of LBO investment firms often dictates their investment horizon and is often relatively well known to the investment community. Some firms tend to specialize in purchasing companies that represent strong initial public offering candidates, with an intention of bringing them public as soon as possible. Others look to make short-term operating changes in their portfolio companies, with a goal of "flipping" these companies to other financial or strategic buyers in a short time frame.

Another telling element of the sponsor's orientation is whether it has favored industries or business types (i.e. whether the company avoids or favors cyclicals, technology-based companies, turnaround situations, or high growth profiles). This orientation will not only signal how the sponsor views the issuer, but will also indicate whether the investment is in line with the sponsor's experience or expertise. Fitch considers how often the sponsor has invested within the same industry and with the same primary underlying credit factors as the company being rated.

Fund Structure

A sponsor's access to capital is of primary interest in assessing the likelihood of its future financial support. Funds with a strong performance track record are generally able to raise additional funds more easily. Fitch evaluates the degree to which the total amount of funds raised by a group exceeds its deployed and committed capital. Many funds will raise separate funds for add-on acquisitions or formally carve out funds for such purposes.

After assessing a sponsor group's disposition toward providing incremental fi-

Case Example

Issuer Profile

- 20-year old niche retailer.
- Founders in mid-40s, not ready to retire.
- Management is strong operationally, but in need of administrative and financial expertise to manage growth.
- $200 million in external financing needed for expansion and remodeling.

Background and Proposal of Sponsor No. 1

- Long investment horizon; recently closed second buyout fund.
- Successfully exited five leveraged roll-ups of specialty retailers.
- Prefers to offer management less up-front consideration to keep it incented.

Background and Proposal of Sponsor No. 2

- Short investment horizon; expect to wind down fund within three years.
- Negligible experience with leveraged retail build-up strategies.
- Always acquires major voting interest; exercises significant control over board-level decisions, including exit timing.

nancial support to its portfolio companies, Fitch reviews the firm's capital capacity when judging its ability to contribute. Investment behavior can be affected and even limited by the composition of the fund's investor base. Some funds are restricted against making investments in particular jurisdictions, in certain industries, or with certain structural components. The sponsor often has strong policies regarding conflicts of interest between its investors and potential portfolio companies.

Formal rate of return and time horizon standards also have a significant bearing on the likely performance of a sponsor. From a creditor's perspective, it is usually preferable for the sponsor to have a long investment horizon. Creditors are not necessarily adversely affected by the sponsor's inclination to exit a transaction prior to the specified loan term. However, groups with the shortest time horizons may be less likely to support an issuer's long-term strategic decisions. A sponsor's financial commitment to a transaction can also be affected by the frequency with which profits are proposed to be distributed to investors.

Example

The theoretical example in the box above and table at right is provided to illustrate how the growth objectives of a leveraged buyout candidate might be more readily achievable through alliance with one financial sponsor than another. In this example, the LBO candidate has two primary financing objectives — providing a certain amount of liquidity to management while the private equity market remains favorable to sellers and obtaining sufficient external financing to support the company's growth expectations over the next five years.

At first blush, it appears that the issuer is better served by pursuing sponsor 2's proposal. This proposal involves a greater up-front cash payment, allows management to participate in future appreciation, and satisfies the company's external financing requirements.

A further review of the proposals, however, reveals significant qualitative differences in the proposals, many of which would not be apparent unless the issuer was prepared to evaluate the

Case Example

($ Mil.)

	Proposal of Sponsor 1	Proposal of Sponsor 2
Total Purchase Price	300	350
Purchase Price Multiple*	6	7
Up-front Cash Payment	75	100
Sponsor's Acquired Ownership (%)	40	60
Management's Retained Ownership (%)	60	40
Debt at Closing	225	250
Debt as % of Buyout Price	75	71
Debt/EBITDA (%)	4.5	5.0
Results		
Five-Year EBITDA Growth Rate (%)	10.0	7.5
Present Value of Management's Returns		
Up-front Cash Consideration	75	100
Five-Year Return on Equity Rolled Over**	217	122
Total Return	292	222

*Using earnings before interest, taxes, depreciation, and amortization (EBITDA) run rate of $50 million. **Assuming exit multiple of six times EBITDA less outstanding debt.

background or track record of the sponsor. Sponsor 1's proposal results in management's retention of a controlling interest in the ongoing operation and alignment with a strategic partner with more industry experience and contacts that would prove useful in furthering its longer term objectives. Sponsor 1 would place this investment in a newly closed fund, and, thus has a longer investment horizon than that of sponsor 2, which is likely to wind down its fund in short order. Sponsor 1's prior successes with retail roll-ups and its ability to augment the company's board of directors with executives from its other retail portfolio companies add value to its proposal.

It is assumed that differences in the investment motivations and backgrounds of the two sponsors would result in different earnings growth rates for the company. This example assumes the company would achieve its 10% earnings growth objective if the company selected sponsor 1 as its equity partner. In contrast, it is assumed that the short-term investment horizon and lack of industry familiarity of sponsor 2 would have a negative impact on the issuer's earnings growth. Having substantially achieved all its investment objectives, this sponsor would become primarily focused on preserving this economic return and on pursuing exit alternatives. This disposition, coupled with sponsor 2's lack of hands-on experience with retail growth strategies, would cause it to become more conservative when voting on strategic initiatives at board meetings, such as capital expenditure proposals outside of "maintenance level" outlays, proposals regarding the number of new store openings, and growth related to administrative and operational personnel additions. In this scenario, sponsor 2's motivations have become irreconcilably divergent from that of management, which has a vested interest in fostering growth.

As reflected in the table on page 4, the present value of management's five-year return on equity would be 24% lower if the buyout proposal of sponsor 2 were selected, despite the higher up-front cash payment and larger overall purchase price. The company's management would have been better served to align itself with a knowledgeable, partner-like equity source, such as sponsor 1.