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Leveraged Finance:

LBO Performance In Europe Falls Behind Expectations As Recession Bites

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The recession is proving particularly worrisome for leveraged buyout companies in Europe, in our opinion. We see that the earnings growth that sponsors hoped to use to pay down debt is not materializing, and, in the current economic climate, investors are forcing restructurings instead of covenant waivers or refinancings. This mismatch between the expectations of 2005-2007 and the realities of 2008-2009 is thrown into sharp relief by Standard & Poor's Ratings Services' latest survey of leveraged loan performance, which finds companies falling further behind their EBITDA projections as they wrestle with often unsustainable levels of debt.

Overall, the performance of European speculative-grade companies that have been through a leveraged buy-out (LBO) has been significantly below their initial forecasts for the year-end 2008. In our latest study of LBO performance, 45% of companies were more than 10% behind forecast on EBITDA at the end of 2008, compared with 31% at the end of 2007 (see article "Credit Conditions Deteriorate For Private Equity-Owned And Leveraged Companies In Europe," published Dec. 10, 2008, on RatingsDirect.

Since early 2008, in an effort to shed some light on prevailing trends in the European leveraged finance market, Standard & Poor's has been tracking the performance of a sample from its private credit estimate portfolio of European leveraged loans, composed primarily of speculative-grade loans backing private-equity buyouts. Information on the specific performance of leveraged loans is difficult to obtain, as the majority are not publicly rated (according to Standard & Poor's LCD, only 6.6% by transaction count and 10.8% by volume were publicly rated in 2008). The results featured in this report are based on data collected from 90 companies across 13 sectors on which we provide credit estimates. We have also used some data from our portfolio of publicly-rated speculative-grade companies for comparative purposes.

When the results of our first study were published in February 2008, year-end 2007 figures showed that 56% of the sample was behind the companies' original EBITDA forecasts (see article "European Private Equity Deals Display Wide Disparity In Performance; More Than Half Lag EBITDA Forecasts", published Feb. 12, 2008 on RatingsDirect). That figure has now sharply increased to 69%. This will come as no surprise to the market, as default figures for 2008 and 2009 have spiked to a recently revised 11.0% trailing 12-month rate in Europe, based on Standard & Poor's publicly rated companies and those with credit estimates outstanding (see article "Leveraged Loan Defaults Continue To Climb In Western Europe As The Slowdown Exposes Structural Weaknesses," also published today on RatingsDirect). We see that when debt for these transactions was marketed to investors during the boom years of 2005-2007, transactions were structured and sold on the basis of solid growth prospects, whether they were first-time LBOs, secondary or tertiary buyouts, or recapitalizations. We therefore believe that a shortfall in sales and EBITDA growth will have serious implications for covenant compliance and the ability to refinance an overleveraged balance sheet.

Performance Variance Continues To Widen

Companies were 6.9% behind their median EBITDA projections at the end of 2008. This data has a very wide variation, with a standard deviation of 20.5% (see chart 1). The variation in performance has increased considerably compared with year-end 2007. Then, companies were only 1.8% behind median EBITDA projections and the standard deviation was 16.2%. There was also a wide variance across industry sectors at the end of 2008. For the worst-performing sectors, such as health care, chemicals, and packaging, underperformance ranges from 15%-17% behind forecasts.

Many companies in our study were experiencing severe underperformance by the end of 2008, with 45% more than 10% behind forecast EBITDA (see charts 2 and 3). This trend is reflected in the increase in defaults in 2008. Of our sample, 11 companies, or 12.2%, have experienced a payment default, filed for insolvency, or are undergoing a restructuring. The median EBITDA performance for these companies was 29% behind the original forecast at year-end 2008, while the median sales figure was down 18.6%. And 18 companies (20%), including those that have defaulted, have either breached covenants or asked lenders for a waiver or amendment to covenants. This compares with the last update of our study in December 2008, when 12.5% of companies in the study had covenant-related problems.

Chart 1

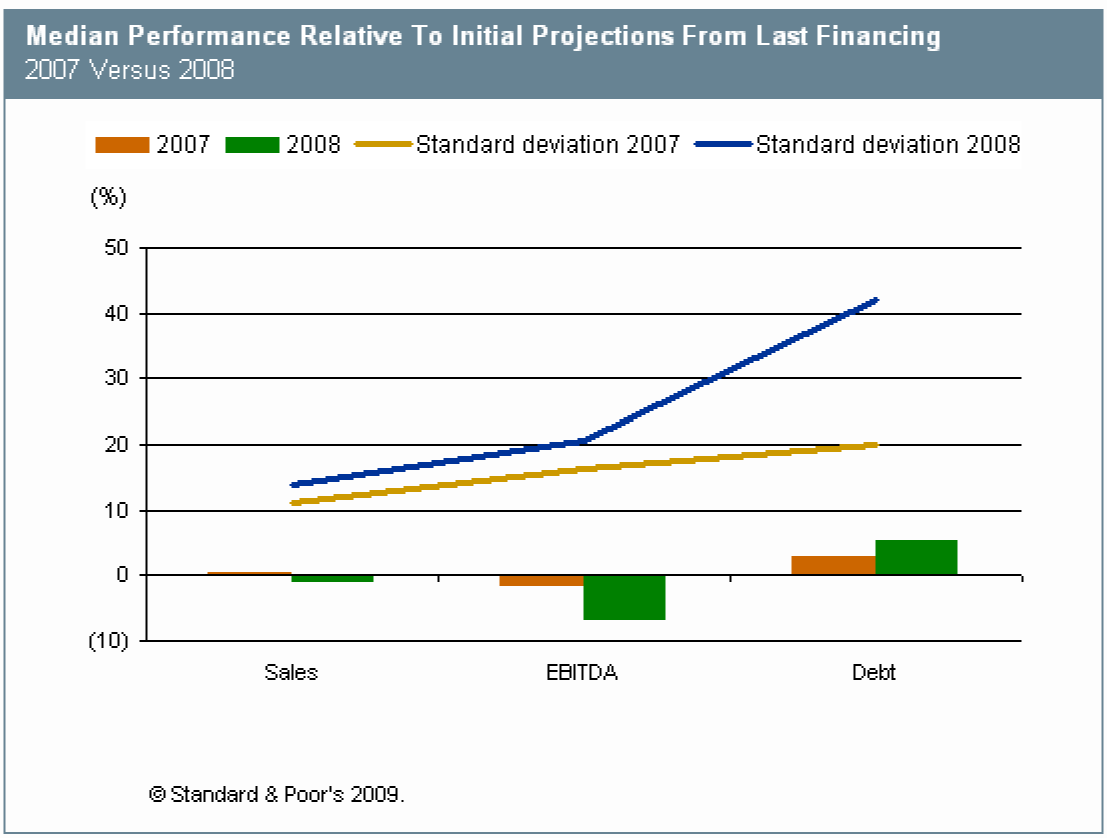

Chart 2

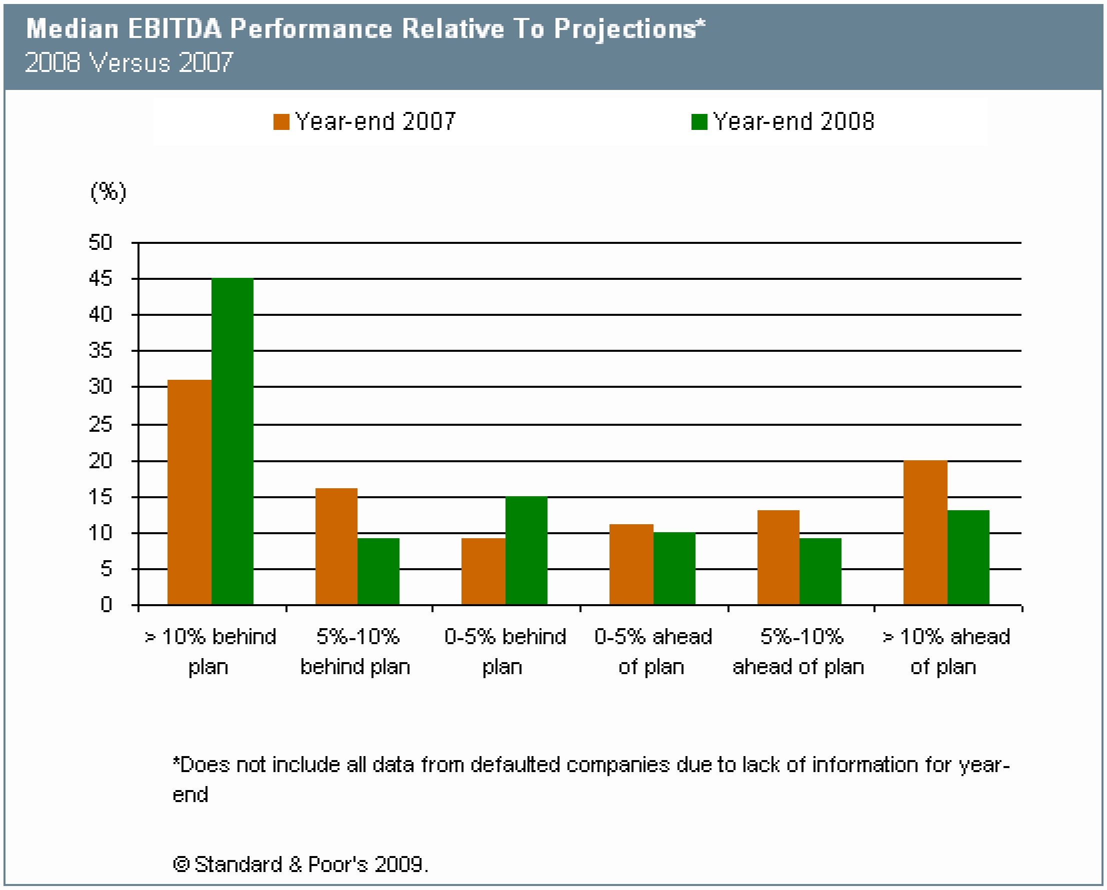

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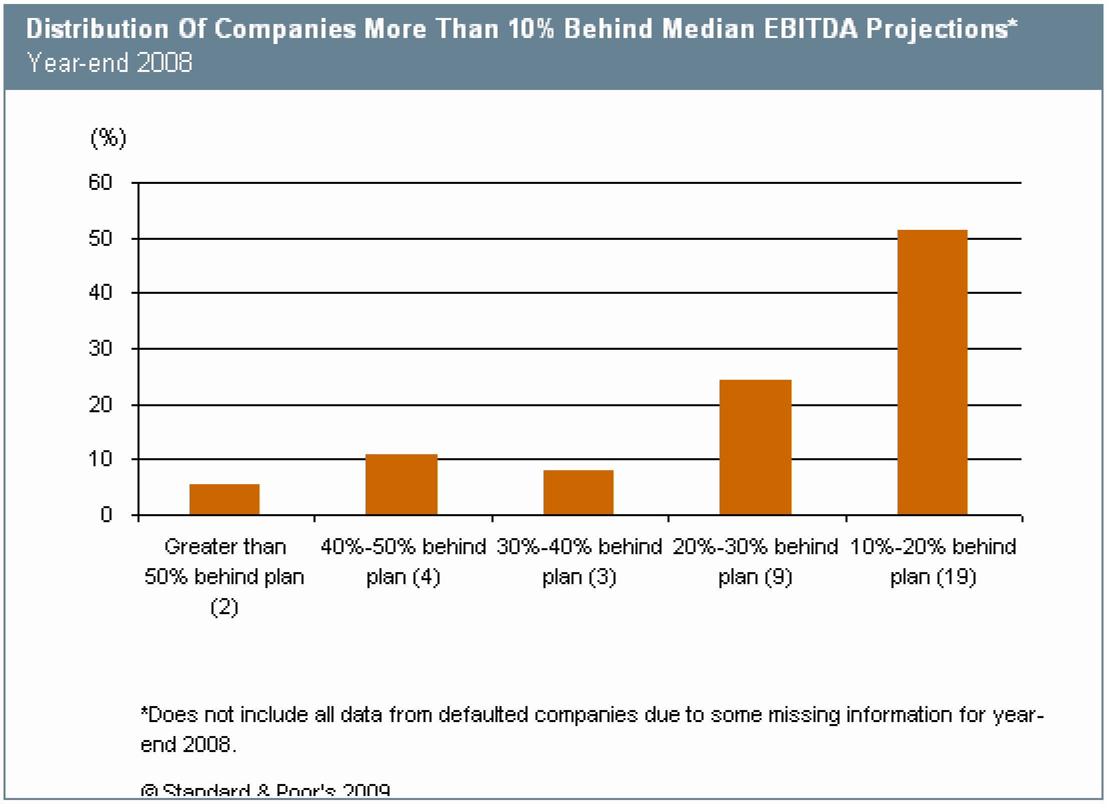
Chart 3



Operating Performance In Some Sectors Has Been Particularly Poor

The majority of companies in our study are now experiencing a deterioration in operating performance and the predictability of future demand--particularly in sectors such as real estate and home building--remains low. Budgets prepared in 2008 now look optimistic, we believe, and have been reforecast to levels lower than the actual figures recorded in 2008. What's more, there is evidence that these 2009 budgets are still being revised downward as management teams grapple with uncertain future demand.

Suppliers to major manufacturers, meanwhile, are suffering from the effects of destocking as consumer demand falls. In the fourth quarter of 2008 and the first quarter of 2009, wholesalers and retailers avoided placing new stock orders as they tried to shift existing inventory. Auto suppliers, in particular, suffered greatly as the automakers cut back their stock orders in line with the collapse in auto sales. We understand that some stock reordering is now occurring, but suppliers are still suffering the effects of previous quarters. By contrast, food retailers, along with other retailers, are in a better position, as they have more flexibility to cut costs, in our view. They also have a shorter working capital cycle. Although demand in general has fallen--particularly for luxury goods and discretionary items--we believe that most retailers can survive on smaller margins in the near term. Chemicals companies, on the other hand, have been hit hard by falling demand because their high fixed-cost bases cannot be adjusted quickly. This was exacerbated by rising raw material prices in 2008.

For example, BorsodChem, a chemical company in Europe, is going through a restructuring with its lenders, according to reports from S&P LCD. It has been hit by falling demand in the industries that use its products, which include construction, automotive, and furniture companies. BorsodChem recently put in place new management and has started to cut costs, LCD said, but has been overtaken by the speed of the slowdown. (We are citing BorsodChem as an example known in the market, but Standard & Poor's does not disclose any of the LBO companies included in our study, or any of the companies on which we maintain credit estimates).

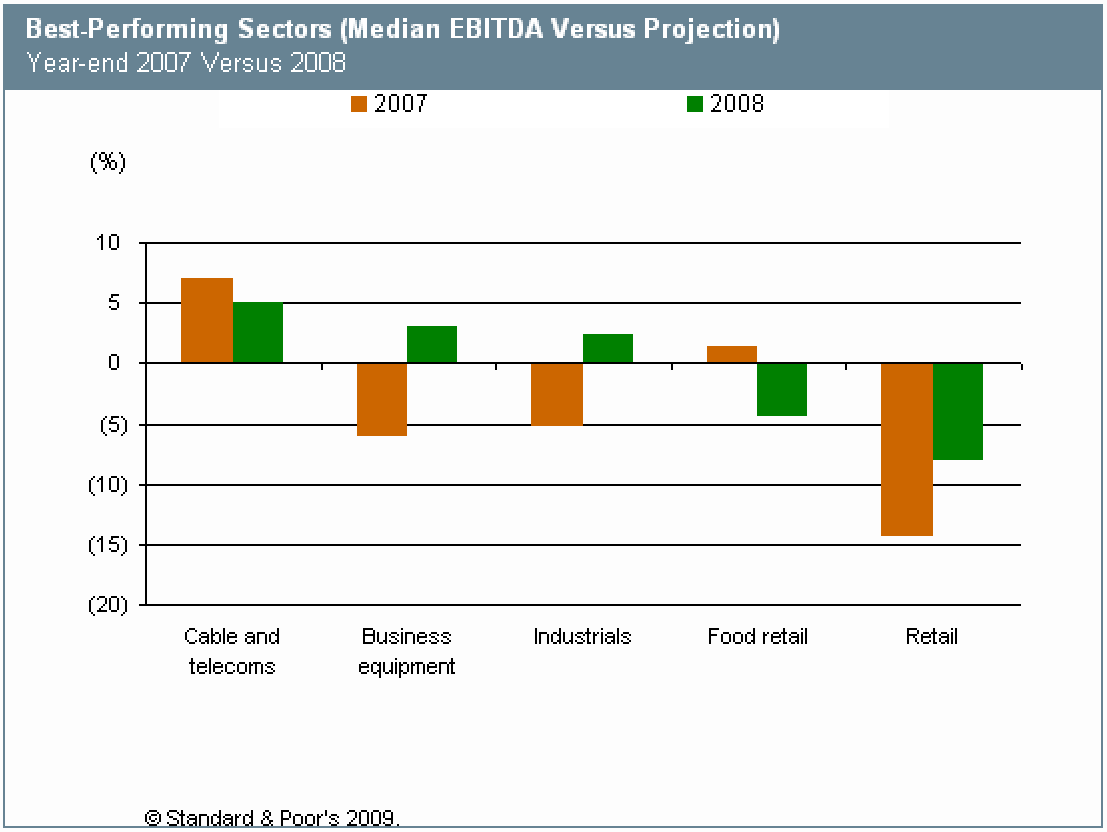
Sales at a number of companies appear to have grown rapidly from year-end 2007 to year-end 2008. However, closer inspection reveals that this is mostly due to acquisitions, which can also increase debt levels at the same time. Meanwhile, companies with high fixed-cost bases were not able to adjust quickly to a sharp drop in demand. Others had high levels of capital expenditure (capex) and were not able to increase EBITDA quickly enough to compensate for this.

As an example, another LBO in Europe, food-retail business Service Select Partners (SSP), has now defaulted through a missed interest payment, according to LCD. Lenders have been concerned about the company's lack of EBITDA growth since March 2009. According to LCD, lenders were worried about SSP's drive to increase the number of outlets it operates, and the accompanying high capex spend, since they did not see EBITDA growing in line with the expansion of the business.

In an effort to deleverage their balance sheets, some of the companies in our sample have received equity injections from their sponsors, since increases in profitability have not been sufficient to decrease their ratio of debt to EBITDA.

Not all sectors posted a decline in their EBITDA performance relative to that projected at the end of 2008. Cable and telecommunications, business equipment, industrials, food retail, and general retail generally performed according to plan. Two of these, business equipment and industrials, even improved their performance relative to that at year-end 2007 (see chart 4). The worst performing sectors were health care, chemicals, packaging, publishing, autos, building, and food products (see chart 5).

Chart 4



Best-Performing Sectors (Median EBITDA Versus Projection)
Year-end 2007 Versus 2008
2007
2008
(%)
10
5
0
(5)
(10)
(15)
(20)
Cable and telecoms
Business equipment
Industrials
Food retail
Retail
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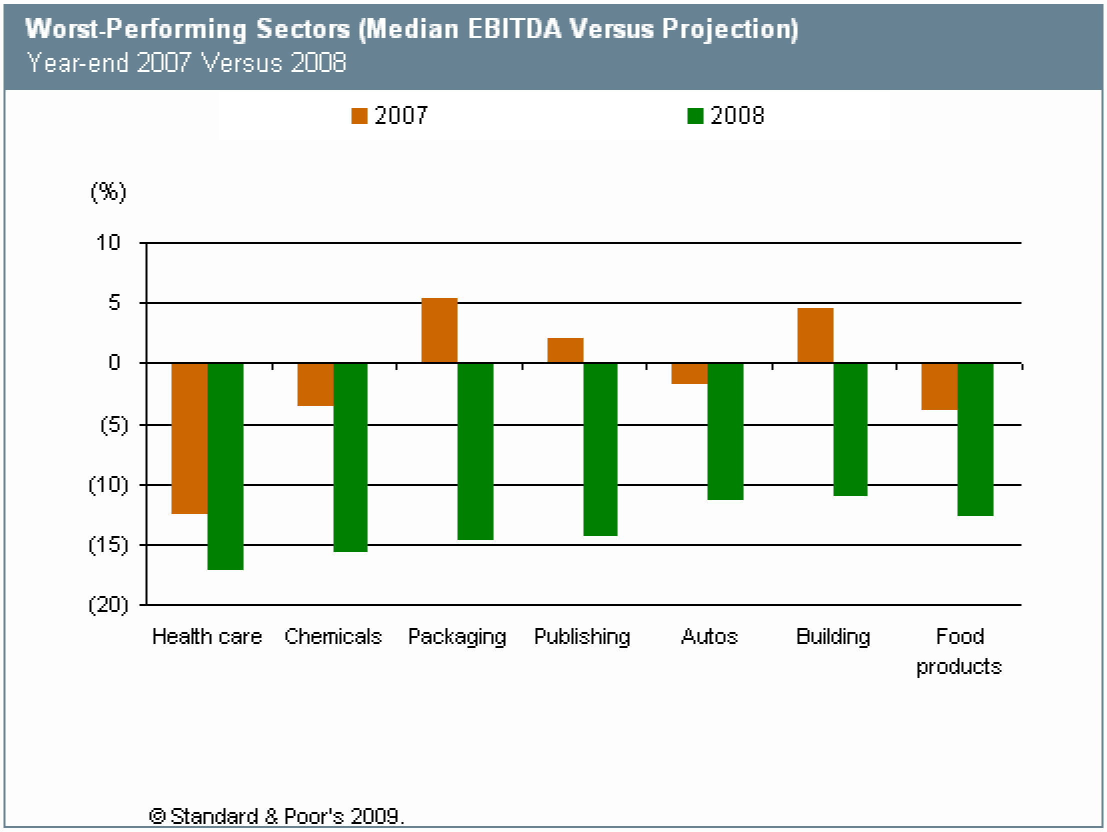
Chart 5



Deleveraging Is Not Possible Without EBITDA Growth

Leveraged buyouts are typically intended to expand a company sufficiently to generate enough cash to begin to repay debt, as well as reduce its leverage ratios. When sponsors purchase these companies, they usually show potential investors detailed proposals for how they plan to accomplish this, including specific projections for sales, EBITDA, and absolute debt levels. This presupposes that companies will be able to pay back debt using earnings growth. However, as our data show, in the majority of cases, the sponsors' planned earnings growth did not materialize. This has resulted in absolute debt levels relative to forecast increasing in 2008 from 2007. At the end of 2008, average debt levels were 11.4% higher than originally planned. A year earlier, the figure was 6.6%. The averages are much higher than the median figures for this data as the standard deviations increased dramatically to 41.9% from 20.1% (see chart 1).

We have seen that the typical LBO strategy of cutting costs and increasing profitability and cash flow to pay back debt can work well for companies that are traditionally able to sustain high amounts of leverage. However, in the push to find suitable transactions, companies that were cyclical or needed high levels of capex, for example, in our view took on unsustainable levels of debt. Headline figures generally focus on the bigger transactions with high absolute leverage, such as VNU World Directories, now called Truvo Subsidiary Corp. (CCC+/Negative/--), or Alliance Boots (not rated). That said, there were many smaller transactions with lower debt multiples that were to prove unsustainable, and these also contribute to the high rate of defaults.

Cash Flow Protection Measures Appear Weak

The weakness of the average cash flow protection measures--EBITDA to net interest, funds from operations (FFO) to net debt, and debt to EBITDA--of the companies in our study is a direct result of lower-than-expected EBITDA growth. In most cases, where leverage has shot up substantially, the cause was an absolute decline in EBITDA as a result, we believe, of the weakening economic environment. Some companies were able to improve their working capital or cut capex to improve their cash flow or leverage ratios. However, we see that very few companies are deleveraging through true growth in profitability and cash flow.

The average EBITDA-to-net-interest multiple for the companies in our study is 2.2x, while FFO to net debt is 10%. These are close to the average metrics for a company with a credit estimate of single-b in the sample. Average leverage (net debt to EBITDA) of 7.6x is slightly higher than the average level (6.5x) for a 'b' credit estimate in the sample (see table 1).

The credit metrics for the companies in our study are, on average, slightly worse than those for our publicly rated portfolio. But in the speculative-grade category, companies that pursue a public rating generally have a higher rating than those without a public rating. As an example, for the companies in our study with credit estimates ranging from 'bb-' to 'b-', only 6% are at the 'bb-' level. The equivalent figure in our publicly rated portfolio is 28%. Similarly, of the companies in our study within that range, only 17% have a credit estimate of 'b+'. For our publicly rated speculative-grade portfolio, that figure is 36%. (See tables 1 and 2.)

In general, in our opinion, the credit quality of companies in our sample has fallen significantly since we first published the results of our study in early 2008. The number of credit estimates at 'b-' and 'ccc+'-to-default both grew, while the number of credit estimates at 'bb', 'b+', and 'b' declined (see chart 6).

Table 1

Average Credit Metrics Of Credit Estimates In Our LBO Performance Study ('bb-' To 'b-' Categories)

(Most recent credit estimate review)

No. of companies	Credit estimate	EBITDA/Net interest (x)	FFO/Net debt (%)	Debt to EBITDA (x)
4	bb-	3.7	19.3	3.7
12	b+	3.1	16.3	4.1
34	b	2.2	8.9	6.5
22	b-	1.8	4.7	9.1

FFO--Funds from operations.

Table 2

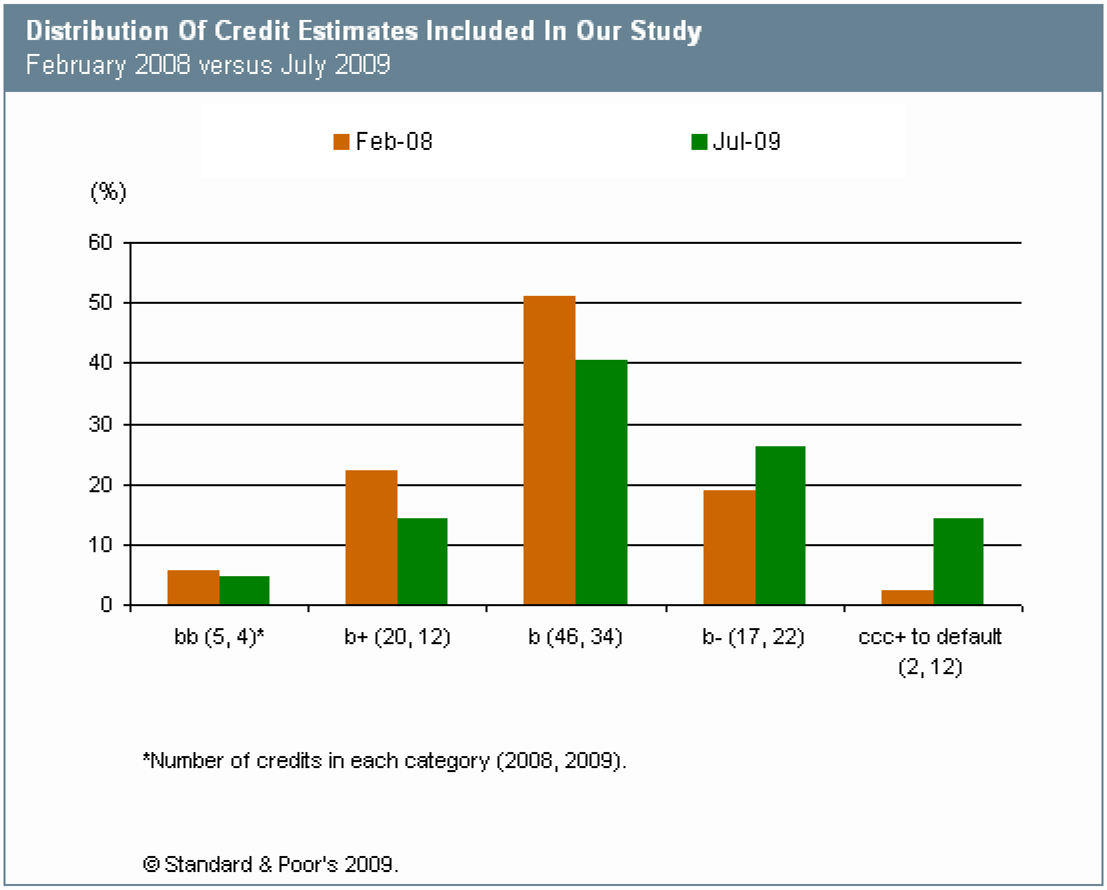
Average Credit Metrics Of Companies Publicly Rated By S&P ('BB-' To 'B-' Categories)

Fiscal year-end 2008

No. of companies	Rating	EBITDA/Net interest (x)	FFO/Net debt (%)	Debt to EBITDA (x)
27	BB-	5.7	32.1	4.3
35	B+	3.7	15.8	4.7
20	B	2.0	11.1	5.6
14	B-	1.6	4.2	8.7

FFO--Funds from operations.

Chart 6



Covenant Breaches Can Quickly Lead To Defaults

In our opinion, the majority of reported covenant breaches in 2008 were technical. What we see as very aggressive plans to deleverage through EBITDA growth meant that companies breached covenants even if their operating performance was healthy. Now, however, most breaches no longer fit in this category. Rather, they are triggered by true operating difficulties. We see that in many cases this results in liquidity problems for management, because companies are usually unable to rely on undrawn revolving credit facilities when in breach.

Waivers and resets, which were relatively easy and quick to agree on in early 2008, have become harder to obtain. As a consequence, toward the end of 2008 and throughout 2009, covenant breaches have often led more quickly to defaults. In the second half of 2008, the average time from a financial covenant breach to a payment default, distressed debt exchange, or restructuring contracted to 2.0 months from 7.5 months in the first half of the year.

Of the transactions included in the study, 56% were syndicated in 2007, 36% in 2006, and 7% in 2005 or earlier. Transactions from 2006 and 2007 are suffering from underperformance due to aggressive growth projections, in our view. Default rates have risen substantially in 2009 and we believe that the peak in Europe may occur later in 2009 as the full 12 months of trading following the bankruptcy of Lehman Brothers translates into a higher level of defaults. This will, in our view, cause more companies to breach covenants and force them into standstills and restructuring negotiations with lenders.

Could More Conservative Structures Bring Greater Stability?

Looking forward, we aim to focus our attention on whether such restructurings address the fundamental problems faced by companies that are in default. We believe that many companies, sponsors, and lenders are simply buying time: By extending term loan A maturities, converting cash interest payments to payments-in-kind (or taking advantage of lower interest rates), and taking out any balance-sheet solvency tests to avoid taking painful write-offs now, in the hope that the economic outlook, and therefore valuations, will eventually improve.

In our view, the leveraged finance market in Europe is truly being tested in this current recession, mainly because it differs so fundamentally from the nascent market that existed in 2003, before the influx of capital that expanded the capacity for borrowers to raise record amounts of debt. To enable the market to recover and attract capital again, we believe that new and restructured transactions will need to revert to more conservative structures, with lower leverage, tighter documentation, and greater investor protection.

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