

Steering clear of LBO risk

LBO paranoia has infected the credit markets and threatens to upset the returns of investors already knocked by the recent correction in spreads. Can bondholders escape the LBO menace? **Laurence Neville** reports

Goldman Sachs Capital Partners and private equity group EQT's bid for ISS at the end of March made the Danish cleaning services company the largest European issuer ever to be the target of a leveraged buyout (LBO). Now, almost any company seems to be a potential target – and considering the dire consequences an LBO entails for spreads, ratings and subordination, investors are understandably concerned.

The list of candidates being talked about as potential takeover targets is huge: 64 names are

Rumours of unlikely leveraged buyout candidates have the same effect as rumours of credible candidates: spreads widen on credit default swaps (CDS) and bonds.

“Even if named targets don't come to fruition, investors have to be concerned because it impacts spreads,” explains Ian Robinson, head of credit strategy at F&C Asset Management. Some bankers note off the record that many of the leveraged buyout rumours seem to emanate from hedge funds, which could use any widening to cover their short positions cheaply.

Regardless of where rumours start, the effect on bondholders can be destabilising, according to Karl Bergqvist, head of research for credit investment at Gartmore Investment Management. The ISS LBO sent spreads on its 2010 and 2014 bonds from 75bp over swaps to 350bp almost immediately. “If it was 1% of your fund and your target is 75bp a year, then you would lose a third of your performance instantly,” says Bergqvist.

As Suki Mann, head of credit strategy at SG CIB, notes, over the past six months many investors have justified buying tightly priced new issues for diversification reasons. But now that same diversification means they have an increased risk of being hit by an LBO. Furthermore, for index trackers there is little choice but to buy bonds that could potentially devastate your returns.

In vogue

LBOs are a hot topic for a number of reasons: private equity funds have a lot of money to invest; the all-in cost of borrowing is low and can be more than compensated for by many companies' free cashflow; and we are at an attractive point in many sectors'

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included in *Credit's* list, which was compiled from those put forward in recent bank research reports.

Many of these names are arrant nonsense: only a tiny number of LBOs occur every year, and the likelihood that a company such as DaimlerChrysler, for example, could be bought by a consortium of private equity players – even in an era of club deals such as the \$10.8 billion bid for SunGard Data Systems in the US – is limited. In GM's case, its liabilities put it out of reach for almost any bidder.

But the daily gossip of the leveraged buyout world has left investors shell-shocked. Given the already limited upside in the investment-grade market, bondholders, to misquote Franklin Roosevelt when he first took office, must now fear fear itself.

business cycles, according to Matt King, head of quantitative credit strategy at Citigroup.

An additional reason for bondholders to worry is the emergence of club-style deals, says Vivek Tawadey, head of credit strategy at BNP Paribas. He says that such arrangements, seen in the ISS bid, allow large transactions to be financed quickly. Therefore the potential range of LBO candidates widens and investors need to be even more cautious.

While there are solid financial reasons for the increase in LBO activity – and the increased fear of LBOs – it is not coincidental that concerns about have reached fever pitch now. “We put out a piece on LBO risk exactly a year ago and all of the reasons why LBOs were attractive and feasible then still apply today,” says Arndt Muthreich, head of credit research at Dresdner Kleinwort Wasserstein. “But the current panic has come after spreads have widened due to concerns over the auto sector and investor risk appetite was already fragile. The market is vulnerable to bad news.”

What is undeniable is that there are few circumstances in which an LBO can be attractive for bond investors. During the course of the famous ‘Barbarians at the Gate’ \$31.4 billion acquisition of tobacco and food corporation RJR Nabisco by Kohlberg Kravis Roberts in 1989, RJR’s ratings fell six levels from single-A to double-B. By definition, a leveraged buyout increases leverage, notes F&C’s Robinson. So faced with dozens of names which might, or might not, be potential LBO candidates, what can investors do?

How to avoid trouble

In order not to be caught holding LBO candidates, it is important to understand what private equity players want. They analyse potential targets in three main ways: valuation; credit and cashflow; and operations. In terms of valuation, undervalued companies – for reasons of poor management, because a company is part of a conglomerate, or cyclical reasons – are desirable.

The second analysis, credit and cashflow, revolves around how much leverage a company can take so private equity houses can work out how much to pay. Stability of cashflows is vital for this analysis and also to aid in the repayment of the debt taken on to buy a company. What assets, such as property or non-core operations, are available to sell to pay for the acquisition or raise funds for investing in the ongoing business are also important, says James Ravine, credit analyst at Barclays Capital.

Finally there is the less easily definable area of operational analysis. As Citigroup notes, financial sponsors frequently add value by improving how a business is run or by growing the company either organically or through acquisition. ISS, for example,

has made a series of acquisitions in recent years which have added little in respect of earnings or profits, making it an attractive target. Conversely, although Woolworths might look inefficient at first glance, analysts note that it is reasonably well run.

Investors need to look for names which tick as few boxes for private equity sponsors as possible and reassess their entire existing portfolio, according to Tawadey at BNP Paribas. In addition to avoiding

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underleveraged, undervalued and poorly performing companies with strong market positions – the hottest example being Boots – there are a number of other characteristics that could help investors find non-LBO target names.

Rob Orman, consumers analyst at Royal Bank of Scotland, says that size is one factor and even with club deals, anything with an enterprise value of more than £10 billion is an unlikely LBO proposition. Similarly, large pension deficits ward off buyers. Although the pension deficit of UK retailer Marks & Spencer was not pivotal in its suc-

Strategies to take advantage of LBOs

For large real-money investors, who might hold up to £70 million in one bond, LBO rumours can be a nightmare. Given the size of their stakes, such investors face an unpalatable choice of taking a huge mark-to-market hit – or a real hit should an LBO actually occur – or selling out, which will trash the market.

A small but growing number of real-money funds, and of course other less constrained investors, do have alternatives to the LBO dilemma. “If you can use the CDS markets or can go short, there are ways to reduce your downside or to take advantage of speculation on LBOs,” says Arndt Muthreich, head of credit research at Dresdner Kleinwort Wasserstein.

Vivek Tawadey, head of credit strategy at BNP Paribas, says long-short fund managers have a number of strategies at their disposal, such as buying protection on a basket of LBO targets and selling protection on the market (using iTraxx non-financials) or buying first-to-default protection on LBO targets and selling protection on the market.

Other strategies include steepening the curve on LBO targets by buying 10-year protection and selling two-year protection. And capital structure traders could consider buying out-of-the-money calls on LBO targets, and selling protection on the market (using iTraxx non-financials).



Muthreich, DrKW:
investors can benefit from LBOs by using CDS or going short

successful defence of Philip Green's bid, it was important, says Orman.

Companies with substantial controlling shareholders, such as families, are likely to be less susceptible to LBOs, provided the shareholder is not eager to sell. Orman says names like Sainsbury's, Morrison, Carrefour, Henkel, Metro and LVMH seem unlikely targets given the unwillingness of those controlling the company to sell. There are also companies which have shareholder structures that will delay if not prevent an LBO, such as Reuters, which has a limit of 15% on individual shareholdings and a special 30% voting right for the founders.

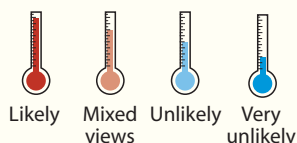
The maturity of a company's outstanding bonds can be a good guide to what is safe to buy, according to F&C's Robinson. Banks lending money to private equity companies generally expect their money returned within five years and do not want outstanding bonds to interfere with the repayment of their loans.

That means short-dated bonds may be bought back. Even those bonds without protection could be bought back at an attractive price in order to quicken acceptance of an LBO. Any bonds outside the five-year time frame are likely to be hit the hardest as they will probably be structurally subordinated

The LBO hitlist

Dozens of companies have cropped up in research reports and the financial press as possible leveraged buyout candidates. We assess the LBO potential in individual cases

Key:



Boots 5-yr CDS high: 132bp 01/04/05: +77bp 03/05/05: +112bp	Strong cashflow, a lower EV/Ebitda multiple than UK retail peers, no pension deficit and disposal assets make this a prime medium-term LBO target, notes Citigroup.	Tomkins 5-yr CDS high: 64bp 01/04/05: +36bp 03/05/05: +64bp	Citigroup acknowledges Tomkins' strong market position but says its quality management could make it hard to push for a change.
Brixton	The company's low market cap and short leases make it a target, argues Citigroup. But the company is focused on industrial properties, which makes it less attractive and its 2019 bond is heavily covenanted.	Valeo 5-yr CDS high: 118bp 01/04/05: +62bp 03/05/05: +95bp	Benefits from solid industry positioning, strong financials and an excellent management team, says BNP Paribas. Citigroup says it is a target, claiming management has lost credibility with investors.
Degussa 5-yr CDS high: 64bp 01/04/05: +36bp 03/05/05: +64bp	Decent free cashflow. E.ON is required to sell its 42% stake but RAG owns 50% and doesn't want to sell. Its €7 billion market cap makes it large for an LBO, notes Citigroup. SG CIB says an LBO is still possible.	VNU 5-yr CDS high: 68bp 01/04/05: +52bp 03/05/05: +64bp	Although the company is run as a not-for-profit foundation, which could slow an LBO by two months, it is underleveraged and a medium to high LBO probability, according to Citigroup.
GKN 5-yr CDS high: 105bp 01/04/05: +83bp 03/05/05: +104bp	As a conglomerate, GKN is ripe for break-up, says Citigroup. It also has a net cash position. But management is good, making it hard to support a change of control and it has a pension deficit.	Wolters Kluwer 5-yr CDS high: 61bp 01/04/05: +32bp 03/05/05: +61bp	Low leverage and at the low end of valuations for its sector but Dutch law gives the firm the potential to delay an LBO, says Citigroup
Imersys 5-yr CDS high: 55bp 01/04/05: +54bp 03/05/05: +55bp	Despite the Pargesa family owning 27% and Group Bruxelles a further 26%, an LBO is a strong possibility, says SG CIB.	Centrica	A large and complex working capital cycle that ties up cash makes an LBO hard, says Citigroup. Plus the company needs to invest substantially in capex making it unattractive.
ITV	Media companies like ITV and Emap could be candidates given their size, low capex intensity and relative stability of cashflow, says BNP Paribas. Citigroup notes that ITV is underleveraged.	Ciba	Still integrating an acquisition from 2004 and shareholders may want to wait for synergies, says Citigroup. SG CIB calls it a very possible LBO.
Kelda	Citigroup says this is a good time to LBO in the UK water market, as the five yearly price setting occurred at the end of 2004, giving five years of cashflow visibility. Kelda is underleveraged and vulnerable.	Compass 5-yr CDS high: 81bp 01/04/05: +58bp 03/05/05: +77bp	Excitement over ISS has over-impacted Compass's spreads, says Citigroup. Its limited fixed assets make an LBO unlikely.
Marks & Spencer 5-yr CDS high: 129bp 01/04/05: +110bp 03/05/05: +113bp	Philip Green could still make another attempt to buy M&S, believes Citigroup, as the company is far from being described as an unqualified success.	Dixons 5-yr CDS high: 103bp 01/04/05: +84bp 03/05/05: +85bp	Well run and unlikely a financial buyer could do better, says Citigroup. Most stores are already leased removing the opportunity for property sales.
Pennon	The small scale of the company makes it susceptible to an LBO, believes Citigroup. But the company's outstanding bond is heavily covenanted and offers protection against a steep increase in gearing.	DSM 5-yr CDS high: 50bp 01/04/05: +40bp 03/05/05: +50bp	Although DSM is at a slight discount to its peers and has fairly low debt, Citigroup notes that it has high research costs, the chemical cycle is reaching its peak and there is not enough to be gained from an LBO.
Slough Estates 5-yr CDS high: 69bp 01/04/05: +36bp 03/05/05: +63bp	An underperformer with non-core assets available for disposal. But disparate assets could make it a tricky LBO, says Citigroup.	FKI 5-yr CDS high: 162bp 01/04/05: +122bp 03/05/05: +162bp	Some dissension among banks from SG CIB's view that this is an unlikely candidate. One bank, which chose to remain anonymous, has FKI as a high probability LBO target.
TDC 5-yr CDS high: 155bp 01/04/05: +35bp 03/05/05: +99bp	Given TDC's size, valuation and financial profile an LBO is a possibility, according to RBS. DrKW agrees that TDC is the most likely LBO candidate in telecoms but says there may be government resistance.	GUS 5-yr CDS high: 68bp 01/04/05: +53bp 03/05/05: +57bp	One of the best-run retailers in the UK and trades at a premium to reflect this, making a bid unlikely, says Citigroup.

and may not be bought back, notes David Newman, co-head of European credit research at Citigroup.



















Finally, and most obviously, investors can seek out bonds which offer protection such as a change-of-control clause or negative pledge, which restricts subordination. Robinson labels anything without protection “a gamble” but in truth there are few opportunities out there – especially in euros. In sterling, Sainsbury’s is a notable exception, as its bonds have to be bought back at par if it is downgraded to non-investment grade. As it trades below investment grade currently that could prove an attractive situation for investors.

Barclays Capital’s Ravine also points out that Rentokil Initial bonds have change-of-control protection. “But investors should not assume that a change of control makes a company unattractive for an LBO,” he says. “It depends on the amount of

outstanding bonds, their maturity and other covenants such as negative pledge language.”

Bergqvist at Gartmore says the current market offers a good opportunity to restart the debate over minimum standards in covenants. “It’s amazing that it took ISS for people to wake up,” he says. The difference in spread change between Sainsbury’s and Safeway when both were flagged up as potential LBO targets highlights the issue. “The change-of-control covenants in Sainsbury’s bonds made the world of difference to investors,” he says.

Certainly, two deals launched since the ISS bid – Syngenta and Wienerberger – have offered investors protection. But it remains to be seen whether investors will keep up the pressure if, for example, the market moves back to a tightening phase and demand once again outpaces supply of new issues. ■

	ICI 5-yr CDS high: 64bp 01/04/05: +36bp 03/05/05: +64bp	Not a target as ICI no longer offers enough of a discount or room to leverage up, says Citigroup. But SG CIB views it as a very possible LBO candidate with seven institutions owning around 35% of the firm.
	Linde 5-yr CDS high: 72bp 01/04/05: +36bp 03/05/05: +59bp	Disparate assets could make it profitable to break up but management and three large German institutions are opposed to any break-up, according to Citigroup.
	Rentokil Initial	Both its sterling and euro bonds have puts at par making an LBO expensive. But the company does have non-core assets to sell, notes Citigroup.
	Securitas	Any deal would probably be too expensive for the sponsors, estimates Citigroup. In addition, a dual shareholding structure makes an LBO complicated.
	Union Fenosa 5-yr CDS high: 59bp 01/04/05: +48bp 03/05/05: +48bp	Recently the subject of rumours regarding interest from CVC, says BNP Paribas. SG CIB says the Spanish government would not want the company to become non-investment grade.
	Cimpor	As a family-owned company with an unstable cashflow, the likelihood of an LBO is limited, according to SG CIB.
	mm02 5-yr CDS high: 69bp 01/04/05: +36bp 03/05/05: +63bp	It would have to be valued north of €12 billion for a takeover bid to succeed (current market cap is €10.6 billion) making it the largest European LBO by some margin, says RBS.
	Reuters 5-yr CDS high: 35bp 01/04/05: +26bp 03/05/05: +28bp	Despite low leverage and limited bondholder protection, the company is an unlikely target given shareholder safeguards, according to Citigroup.
	Rexam	Management is well regarded, says Citigroup, and unlikely to want to lose the ability to fund acquisitions though either equity or debt.
	Rodamco Europe	Protected by leverage restrictions under Dutch real-estate investment trust law, according to Citigroup.
	Rolls-Royce 5-yr CDS high: 48bp 01/04/05: +38bp 03/05/05: +42bp	Unlikely, according to SG CIB, which notes seven holders have 40% of the company.
	Sainsbury's Month high: 132bp 01/04/05: +117bp 03/05/05: +117bp	Its ongoing underperformance makes it a possible target, notes Citigroup. But large family shareholding and significant pension deficit may mitigate against an LBO. Sainsbury's bonds are well protected.
	SES Global 5-yr CDS high: 68bp 01/04/05: +52bp 03/05/05: +59bp	Although it has high and stable margins, the Luxembourg government directly or indirectly owns 30% of the company and is unlikely to sell, says Citigroup.
	DaimlerChrysler 5-yr CDS high: 183bp 01/04/05: +81bp 03/05/05: +135bp	Already loaded with €76.6 billion of liabilities and with a large pension deficit, legacy costs would just be too large for an LBO, says Citigroup. An extremely costly and risky adventure, agrees BNP Paribas.
	Electrolux 5-yr CDS high: 62bp 01/04/05: +42bp 03/05/05: +59bp	Too expensive for financial sponsors, according to Citigroup. In addition, a dual shareholding structure makes an LBO complicated.
	EMI 5-yr CDS high: 186bp 01/04/05: +176bp 03/05/05: +168bp	Strong covenants make an LBO difficult, not least because it may make securitisation of the company's publishing libraries impossible, which is where the value is, says Citigroup.
	Firstgroup	Despite being cash-generative the company is already well valued and it may be difficult to work the assets harder, notes Citigroup.
	Klepierre 5-yr CDS high: 55bp 01/04/05: +44bp 03/05/05: +54bp	Trades at a fairly large premium to NAV meaning an acquisition could be expensive, says Citigroup.

The following names have also been touted in the financial press and bank research reports as possible LBO candidates:

Likely: Auna, Autoliv, Emap, Hammerson, Hanson, Kingfisher, NIE, Pearson, Pilkington, Scottish & Newcastle, Severn Trent, South West Water, Three Valleys Waters, TUI, United Utilities

Unlikely: Adecco, Continental, M-Real

Very unlikely: Corus, Metso, Rhodia, Scania, Svenska Cellulosa

Original table from SG CIB. Other data/comments (including names not originally noted in the SG CIB table) from Barclays Capital, BNP Paribas, Citigroup, Dresdner Kleinwort Wasserstein, RBS and Credit magazine. 'Likely', 'mixed views', 'unlikely', 'very unlikely' refer to the whether a credit is a potential candidate for an LBO, not whether an LBO will occur.