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Max Frumes/MEDILL
Private equity firms are using more high-yield debt to refinance their investments.

Large private equity firms reap most benefit from flourishing junk-bond market

***by* MAX FRUMES**
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After a nightmare period of frozen credit markets, private equity firms have raced to refinance their portfolio companies using the unleashed junk-bond market, but the opportunity may not be there for long.

The $14 billion Chicago-based private equity firm Madison Dearborn is one of many that have rushed to take advantage. It refinanced 80 percent of its portfolio companies' debt with maturities ranging from several months to two years, with the new maturity dates now extending to 2014 and beyond, said John Canning, Madison Dearborn co-founder and chairman.

Canning said the firm used a mix of bank refinancing and high-yield debt issuance in order to accomplish this.

Because of low interest rates, investment demand for high-yield debt, commonly referred to as junk bonds, has soared. Junk bonds sport higher yields because they're higher risk investments. Those scrambling to buy the higher-yielding debt include bond funds, pension funds, hedge funds and closed-end funds that invest mostly in bonds or other debt. The question is how long the party will last.

"It's a pretty fragile market," says David Chapin, a partner at Ropes & Gray who represents large private equity funds. "All it takes is bad news coming from various quarters around the world to affect it."

Ropes & Gray has been legal counsel in several of these transactions, including for Bain Capital Partners LLC, Thomas H. Lee Partners LP and Clear Channel Outdoor Inc., which issued $2.5 billion in high-yield debt at the end of December, the largest such deal of 2009.

Senior lenders take old route

Big banks are often the first stop for private equity firms seeking debt restructuring, but banks won't lend for new deals, according to Canning.

"There's a big difference between refinancing a credit you already have and taking on new exposure for new deals," Canning said. "[Banks] are basically doing what they should be doing – refinancing," he said.

The banks, as senior lenders, are able to extend the due dates and change agreements to ease the refinancing for relatively stable companies.

"These aren't troubled credits," Canning said. "Most of the businesses bought in [2006 and 2007] by private equity firms were very good businesses." When given a choice of Citigroup, JP Morgan Chase and Goldman Sachs, Canning responded, "Every large bank" is doing these types of refinancings.

Canning posits that Madison Dearborn was able to use large banks to refinance for two-thirds of the firm's approximate 26 portfolio companies. The remaining companies were not highly leveraged if at all, according to Canning.

In some cases, equity sponsors such as Madison Dearborn may have to provide more capital to get the refinancing done. That, in addition to the companies using senior debt to get rid of their more expensive debt, made senior creditors comfortable with extending the maturity dates and lowering rates.

"Most of us brought down our interest costs," Canning said.

But there was still a portion of the debt that needed refinancing, the portion that had less priority than the senior debt that banks were willing to refinance. And that's where the junk bond market comes in.

Junk spreads

High-yield debt assets from U.S. corporations rose to a record $187.57 billion in 2009, according to the Investment Company Institute. At the same time, investors poured $22.3 billion into high-yield bonds -- the fastest pace since the record in 2003.

During the market downturn, credit spreads, or the difference between yields on corporate bonds and ultra-safe Treasury bonds, widened substantially as prices of high-yield bonds fell.

Then as the recovery began, credit spreads began to narrow, which means prices of high-yield bonds rose, goosing the returns of bond funds.

Not only that, the now-abundant source of bonds is not only temporary, it is mercilessly capricious, as evidenced by its recoiling in the face of recent uncertainty about the fate of Greece.

While it's true that as long as people think recovery is in place and don't have anywhere else to go for higher returns on their investments, the high-yield market will continue to see large volume, according to Chapin.

On the other hand, the availability of high-yield debt will shrink as the returns go down. Recognizing this, private equity funds have been refinancing portfolio companies even if the debt hasn't become due, called "pre-refinancing," Chapin said.

Not for everyone

Attorneys representing middle-market or smaller private equity firms say that refinancing the portfolios, and especially finding financing for new deals, is much harder for their clients than the larger firms.

"You need a certain size to get that high-yield piece," said Steven Napolitano, the chair of DLA Piper's U.S. Private Equity practice. He said some of his mid-sized clients can't access the high-yield market.

Tom Stromberg, an attorney at Kaye Scholer who represents many of those smaller to mid-size PE firms, said his clients usually have between $100 million and $500 million in assets under management and look to invest in companies of between $10 million to $250 million in revenues.

He said the portfolio companies of firms like that take on mezzanine debt, which lays claim to a portion of the companies' assets and offers investors high interest rates. Financing could also involve going to a local bank and getting a working capital line of credit, which is more expensive, he said.

John Lekas, the head of one such middle-market bond fund, said in an interview that his firm will buy less risky junk bonds – essentially subordinated paper in larger companies, especially those that carry mostly bank debt. But for smaller companies, it doesn't look so good.

"The smaller companies that have to use the high-yield market will mostly go bankrupt," said Lekas, CEO of Leader Capital Corp.

Though there are always exceptions, with any issuance of less than $50 million "you're going to have a problem," Lekas added.

The U.S. has seen it before. During the 1980s, an executive at investment bank Drexel Burnham Lambert Inc. disastrously expanded the use of high-yield debt for mergers and acquisitions, and corporate finance.

This fueled the leveraged buyout boom and market bubble – and ended in a crash.

The Moving Cliff

Rating companies like Moody's or Standard & Poor's rate the debt. And according to Standard & Poor's, the repayment of this corporate debt is only being delayed and will build up to enormous levels by 2012.

In 2010, there will be $50 billion to refinance. Yet between 2012 and 2014, more than $852 billion in speculative-grade debt will come due, a recent Standard & Poor's U.S. refinancing study says.

"Those that were hanging on by their fingernails before they go off a cliff were able to refinance their credit," says fixed income money manager Marilyn Cohen, president of Envision Capital Management.

Cohen believes there is a bond fund bubble that will result in diluted, if not disastrous, returns.

"When you see people chasing total returns, it always ends in some kind of bloodbath," Cohen said.

"You're seeing it in retail investors who can't live on 1 to 2 percent return," Cohen said. Bank certificates of deposit, or CDs, which normally have higher interest rates than savings accounts, are paying sub-1 percent yields, she says. "So there's a continuation of a massive inflow into high-yield bond funds."

In fact, a record $421 billion went into bond funds in 2009, according to Trim Tabs research.

The money is flowing into the bond funds so fast that managers might not be as selective as they should be, according to Cohen.

"As the money continues to roll into these bond funds, sometimes they just have to shut their eyes and fill the orders," she said. "They're not paid to sit on cash."

"It's just like what we saw in the LBO craze in 2006. [Easy credit] was amenable until it wasn't," she said.

Lekas envisions a healthier market when the federal funds rate – currently with a target rate of between 0 and 0.25 percent – goes higher.

"Banks are making 400 basis points sitting in the corner sucking their thumb," Lekas said. If the interest rate goes up, they will have to do more lending to try and get their outsized returns.

"Moving fed funds up transfers risk from the taxpayers to the banks. It's absolutely necessary," Lekas said.

What it means for private equity

There was an explosion of mergers and acquisitions between 2005 and 2007 fueled by private equity firms performing leveraged buyouts, where they would purchase companies using a high amount of debt.

This was driven in large part by new funding sources, including hedge funds, special purpose entities created by banks, collateralized loan obligations, institutional investors and international purchasers.

According to private equity data provider Preqin, PE deal volume came to $685 billion in 2006 and $659 billion in 2007. During the first half of

2009, as the markets struggled to heal from the credit crisis, that dwindled to $23 billion, according to Preqin.

Several private equity professionals, including Canning, have said recently that they are starting to see some of the more exotic structures only available in more robust debt markets, such as payment-in-kind interest, loans for dividend recaps and covenant light loans.

“Things I never thought I would have seen,” Canning said, speaking on a panel last month.

Payment-in-kind interest is a periodic form of payment in which the interest is not paid in cash, but is rolled into the principal amount.

A dividend recap is when a company incurs a new debt in order to pay a special dividend to private investors or shareholders, while covenant light is a type of loan that is difficult to breach and gives investors more flexibility.

Even with evidence of the survival of these exotic debt structures, there is still not a lot of credit available for new deals, according Alfredo De Diego Arozamena, a senior director in Standard & Poor’s Structured Credit Group.

“I certainly don’t see [covenant lights] coming back any time soon,” said De Diego Arozamena.

He said collateralized debt obligations have not come back yet, but they are expected to.

“Certainly the expectation is that they will come back, the question is when,” he said.

Lastly, the banks aren’t banding together to invest together in larger deals, what’s called the syndication market.

“There hasn’t been a vibrant syndication market,” John Canning said. “That market hasn’t come back.”

Ropes & Gray’s Chapin does not see the market being flooded with those types of private equity deals in the near future.

“I don’t think there’s going to be an orgy [of exotic deals] any time soon,” Chapin said.

Update: An earlier version of this story used PaeTec Communications as an example of a refinancing of a Madison Dearborn company. Though PaeTec did a refinancing in January using high-yield debt, Madison Dearborn sold any remaining stake in PaeTec last year, according to the firm's spokesman Chuck Dorehnmend.

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