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Acquisition Financing: the Year Behind and the Year Ahead

Just like 2007… and not much like it at all.

So it was in the financing markets in 2012. Capital flowed to non-investment grade issuers in amounts reminiscent of the earlier time. However, those issuers mainly seized upon rising debt investor confidence in order to consummate refinancings, repricings and dividend recapitalizations, while the banks that arrange leveraged loan and high yield bond deals remained cautious in providing committed financing for acquisitions. Meanwhile, acquisitions, spinoffs and other transactions by investment grade issuers received strong support from arrangers and investors alike, with significant availability of committed financing for complex deals and favorable execution of debt issuances to close transactions. If the first few weeks are a guide, and barring any significant disruption in the interest rate environment, 2013 promises more of the same, but whether committed financing for high yield deals will continue its slow recovery remains to be seen.

Investment Grade Acquirors

Throughout 2012 and into 2013, the debt markets have been friendly to investment grade corporate issuers, helping debt become an attractive source of transaction financing relative to equity (at least before the latest run in the stock market). In what was then the largest bond deal since 2007, United Technologies placed approximately $10 billion in notes to finance its acquisition of Goodrich, with a strong market allowing the company to sell three-year notes at a 1.2% yield. Later in the year, AbbVie conducted a $14.7 billion debt offering, the biggest ever investment-grade corporate bond deal in the United States, in connection with its spin-off from Abbott – the three year fixed-rate tranche priced to yield 85 basis points over treasuries.

More important for the transaction environment was the ability of investment-grade acquirors to obtain bridge commitments in connection with signing up deals; the willingness of banks to backstop even very large transactions by investment grade issuers allowed dealmakers to proceed with confidence. Recent examples include the $3.5 billion bridge facility obtained by Walgreen's in connection with its transaction with Alliance Boots; the $3.3 billion in facilities made available to Chicago Bridge & Iron to finance its acquisition of The Shaw Group; and the $1 billion bridge that Kellogg signed up to facilitate its acquisition of Pringles.

Leveraged Acquirors

Bolstered by the highest annual investment in collateralized loan obligations since 2007 (more than the prior four years put together), leveraged loan volume also reached a post-2007 peak in 2012. Moreover, a record $346 billion in high-yield bonds were sold, with BB- "high"-yield bonds seeing coupons as low as 4.375%. Strong investor demand continued into the opening weeks of 2013, when the average yield on U.S. high-yield bonds issuances hit an all-time low of 6.11%.

But whereas the volumes of the earlier period (the era of the mega-LBO) were driven by acquisition activity, 2012 issuances generally went to refinancings, repricings and dividends – among the common attributes of which is the absence of a need for committed financing. Banks exercised caution in providing commitments for high yield acquisitions, as fiscal crisis in Europe and political paralysis in the United States contributed uncertainty to an environment that might otherwise have favored significant underwriting. To what, if any, degree the decline in global private equity deals relative to 2011 (set aside 2007) was attributable to underwriter reticence cannot be known, but it is clear that a sizable commitment for even 6 months was expensive in 2012, and a commitment in excess of 8 months often unobtainable, putting real pressure on long lead-time deals. Relatedly, financing commitments typically included more robust "flex" terms – i.e., the ability of an underwriter to alter the terms of a financing in order to achieve a successful syndication – than were seen in 2007. Significant interest rate flex was not uncommon, making it harder for sponsors to determine expected returns on their investments.

This said, the availability of high-yield committed financing grew towards year-end. PVH obtained $4.325 billion in commitments to finance its acquisition of the Warnaco Group, while Carlyle/Stone Point and Apollo, respectively, obtained financing commitments in connection with the purchase of Duff & Phelps Corp. for $665 million and the education division of McGraw-Hill for $2.5 billion. The *Wall Street Journal* noted that the equity portion of LBO financing, averaging 42% since 2008, fell to 33% in the latter half of 2012, close to 2006/7 levels, while leverage multiples during that period were higher than any time since 2007. These statistics suggest that 2013 may see an uptick in private equity activity. The recent announcement of the $3.2 billion purchase by Cerberus of certain assets of Supervalu, with the seller obtaining $2.4 billion in leveraged loan commitments to recapitalize its remaining business, certainly points this direction.

High Yield Developments

The strong demand by investors for debt in 2012 naturally gave rise to some favorable developments in the financing markets from the issuer point of view. In addition to a general loosening of operating covenants – debt incurrence, dividend capacity and so forth – in both bond and bank markets, three related developments merit elaboration. First, "covenant-lite" loans, those without financial maintenance tests, comprised a record 29 percent of institutional loan volume in 2012, *more* than 2007. Second, nearly $6 billion of "pay-in-kind" (i.e., issuer may defer cash interest payments) notes were issued in 2012, a fraction of the total, but heavily weighted to the end of the year and in line with 2006. These developments mean that acquisitions currently being financed may benefit from the 2006/7-vintage tools that highly levered companies used so effectively to deal with volatile conditions over the last few years.

This reality renders the third development, the inclusion of workout-oriented provisions in leveraged loan documentation, all the more important. Prior to the 2008 financial crisis, credit documentation generally prohibited acquisition of loans by borrowers and their affiliates (including private equity sponsors) and required that all payments on loans be distributed ratably among all lenders. During the crisis years, many lending groups assented to amendments permitting both borrowers and sponsors to purchase loans in privately negotiated transactions and/or through Dutch-auction offers to all lenders. These innovations provided liquidity to a market in which the debt of even healthy companies traded at substantial discounts and enabled (in effect) out-of-court workouts that could otherwise have been thwarted by non-participating lenders. But they also gave rise to collective action problems for lenders: if I don't sell at a discount to the company now, another lender will, leaving me with a borrower in an even worse cash position. The genie having left the bottle, these financial crisis band-aids are spreading throughout the market, baked into original loan documentation in various forms (amend-and-extend provisions, allowing borrowers to pay consenting lenders to extend the maturity on their portions of expiring facilities, are one variety). They should prove useful to recent issuers that encounter difficulties in the future, especially those that have time to maneuver due to the absence of financial covenants and/or the ability to defer interest.

On the flip side, lenders have made one advance in the leveraged loan market over the last few years, with call protection having become ubiquitous in 2012, typically in the form of "soft" call provisions giving lenders a 1.0% fee if their loans are refinanced with cheaper debt within a year of closing, and not the more onerous "make-whole" construct found in the bond market. One might speculate that borrowers conceded the point assuming that spreads could not possibly contract further, an assumption that has proven wrong to date.

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In 2009, more than $95 billion in leveraged loans were scheduled to come due in the fourth quarter of this year; as of this writing, no more than $6 billion is set to come due in any quarter in 2013. The next peak is in the third quarter of 2014 when $24 billion in loans are due. Two questions to keep an eye on, both ominous and optimistic: what proportion of the debt coming due in the next 18 months that was not refinanced in the historic market of 2012 is simply beyond refinancing; and will the chipping away of the "maturity wall" that arose out of the historic market of 2007 allow capital to flow back toward a new cycle of dealmaking?

Advance planning for new deals with experienced legal and banking advisors is as important as ever. The rapidly developing financial markets, where terms and pricing available to support deals may change on a weekly basis, means that a carefully developed financing plan early on in a transaction will help take full advantage of market conditions.

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