

# The Journal

## Examining the Debt Effect

By Steve Brady and Paul Melville  
Grant Thornton LLC

Since 2006, Grant Thornton has partnered with the Association for Corporate Growth (ACG) to examine cutting edge issues in private equity. In 2009, we introduced a White Paper series exploring timely topics in private equity, such as how to “Navigate Your Portfolio Through Turbulent Times,” “Next Steps for Private Equity in the Post-Boom Era,” and most recently, “The Debt Effect.” “The Debt Effect,” explores the challenges facing banks and other lending institutions and how these challenges have impacted deal making in the private equity environment. Below we take a closer look at some of the issues discussed in “The Debt Effect,” with input from local experts who deal with lenders and transactions in the private equity market.

### Deal market overview

In 2009 private equity deal value hit its lowest total since 2001. In 2009, according to Dealogic, only 474 private equity deals were completed for a total of \$31 billion. That pales in comparison to the 724 deals completed for a total of \$62 billion in 2008, which was also a less than stellar year for the industry. According to the ACG-Thomson Reuters DealMakers Survey, 72% of respondents expect M&A to increase moderately over the next six months. However, the potential for increase still faces many challenges as the overall economy remains fragile.

One of the reasons for the forecasted uptick in M&A is that seller’s expectations have shifted down to lower multiples and in conjunction with lower EBITDA levels have created an environment where buyers may have an advantage. With some stability in the economy, and some stabilization of the financial results of ►

some companies, lenders have become willing to look at potential deals and consider lending on a cash flow basis, although asset-based lending has become significantly more prevalent.

Another potential factor being considered by many sellers is the upcoming expiration of the 2001 Bush tax cuts which are set to expire December 31, 2010. Without any action by Washington, tax rates on ordinary income and capital gains will increase on January 1, 2011. According to Chris Schenkenberg, a Grant Thornton tax partner in Chicago, “With the upcoming tax rate increases, we expect sellers to look to monetize the potential value in their companies to avoid the impact of the tax rate changes and a potential tax increase.”

#### Lending market transformation

During the financial crisis, many of the “go to” commercial lenders in the Chicago borrowing community changed.

Some disappeared while others have been acquired. Even though the local lending players have seen a dramatic change over the past 18 months, it is expected that the new environment will see an uptick in lending. Yet another factor in the resurgence is the historical presence of Chicago banks that have traditionally not been as active in commercial lending, but have now become the bank of choice for local private equity firms because of their willingness to work with clients to identify the optimal deal structure.

Also, Chicago’s commercial banking community has seen the entry of many new participants that plan to grow long-term relationships with clients in the region.

With the change in players, the loan participants have changed as well. Given that the financial crisis conditions have shifted from a traditional “syndicated loan” market to more of a club deal environment, the market has changed and so have the loan participants. In this new environment, cash flow loans are starting to be discussed and closed, even though asset-based loans continue to drive the market. The bad news is the number of institutions offering them has declined significantly, with the size of the deal being one of the driving factors of receiving a loan.

The other major difference is covenants and pricing. Banks are requiring lower debt multiples and stricter financial and non-financial covenants. In addition, pricing has increased significantly over the “covenant lite” days. But, they remain below 2009 levels with today’s pricing being closer to Libor + 450.

Grant Thornton’s view is that lenders will continue to slowly return debt to the market, assuming loans are repaid and the economy continues to stabilize. Even though the middle market M&A environment still faces a challenging time, the return of the debt market can be seen with some of the large recently announce deals such as the just approved acquisition by Kraft of UK-based Cadbury PLC.

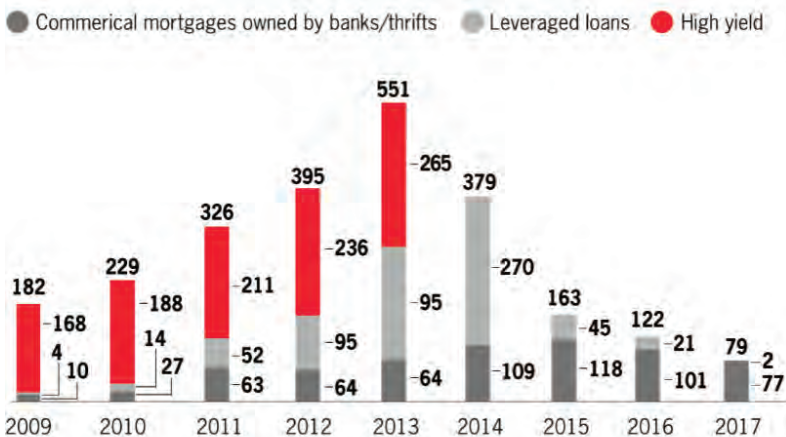
Grant Thornton also believes that the day of “covenant lite deals” will not be seen in the near future, that lending multiples will remain at the current levels, and that a robust level of due diligence will be required on all deals. ►

### Effect of debt market on private equity

Instead of working on new deals, private equity firms have been largely focused on keeping their portfolio companies as healthy as possible. In addition to the items discussed above, one of the other issues on which lenders have become more stringent is the violation of covenants. Historically, if a company triggered covenant violations, most banks would waive those violations without issue. In this environment, with any violation, banks have started to amend or renegotiate the loan agreements to reflect the company's new performance. In many cases, the revolving line of credit has been "pulled," leaving the borrower without funding for working capital requirements. As such, companies have to sell non-core assets to generate operating funds when their revolver is not available.

The number of maturing loans will steadily increase until they are expected to peak in 2013 (Figure, 1). With the large number of loans maturing over this period, which commences in late 2010 and known as the "refinancing cliff," many companies will not be able to renew their revolving line of credit and their term loans due to the contraction in available liquidity, combined with the traditional lenders' increased attention to their lending base and their risk analysis. As a result, many borrowers may not be able to obtain traditional financing, or may need to "amend and extend" their current financing vehicle. In some cases, companies may need to file Chapter 11 bankruptcy or liquidate. This will lead to a great opportunity for private equity firms with high levels of cash to acquire those companies that become unable to meet their debt obligations. Private equity has moved into the role of "rescue financing" in many cases.

#### Maturity schedule



Source: JP Morgan, Standard & Poor's Leverage Commentary & Data and LCD News

To avoid distress sales, banks may be willing to restructure loan agreements by pushing out maturity dates and increasing interest rates. Banks are increasingly willing to renegotiate loan agreements because they believe these actions may save companies from bankruptcy, and if the economy continues to build momentum and businesses rebound, lenders and investors could make their money back, and in some cases, a profit. However, the reality is that many of the amended and extended agreements could lead to bankruptcy down the road as debt from previous years comes due and the borrowers have not addressed the fundamental issues. ▶

Grant Thornton has seen highly-leveraged companies begin to sell marginally performing and non-core assets to obtain cash to service their loans. As result, the deal pipeline is filling up with a number of attractive assets. Buyers are very optimistic based on the type of assets they have seen come to market. With pent up demand for these types of assets, Grant Thornton believes pricing for quality companies will continue to be high.

In addition, for companies to be able to work with their banks and survive they must show revenue growth or operating profit improvement. Stagnant business will end up in distress, and companies that lack investment capital will be at greatest risk for bankruptcy.

We project a slow, gradual increase in deal volume. 2010 is not the year to be overly optimistic, but we expect it to be stronger than last year. The economy is not robust, the job market is still off-kilter, and there hasn't been any huge lending surge in the private equity market, but things are quietly picking up. With all the distressed companies in need of capital, pent-up demand for sales of healthy assets, and the slight thawing of the lending markets, 2010 could prove to be a solid year to start making deals that yield strong returns. ■

The complete whitepaper, *The Debt Effect*, can be found at [www.ACGChicago.com](http://www.ACGChicago.com) under the M&A/PE Network button.

#### About the Authors



##### Steve Brady

National Managing Partner of Transaction Advisory Services

Steve is the National Managing Partner of Grant Thornton's Transaction Advisory Services practice. He has over twenty five years of experience specializing in due diligence for financial buyers, strategic buyers and lending institutions. Steve has extensive experience in mergers and acquisitions and transactions in a number of industries and personal insight gained from holding executive positions in industry.



##### Paul Melville

Principle and Co-leader of Corporate Advisory & Restructuring Services

Paul Melville is a Principal and Co-leader of Grant Thornton's Corporate Advisory & Restructuring Services practice, and is located in Chicago. He has over 15 years experience in corporate restructuring and has advised company management, bank groups, investors, shareholders, customers and suppliers, in a variety of restructuring scenarios including bankruptcy, debt restructuring, and the assessment of strategic options.

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