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High-Risk Debt Still Has Allure For Buyout Deals

Worries Over Inflation, Economy Fail to Curb Investors' Hunger For Potentially Troubled Loans

By HENNY SENDER
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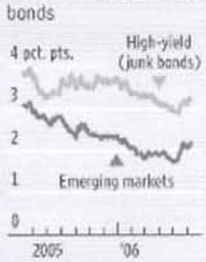
At a time when stock markets across the world are spooked by the contradictory demons of higher inflation and lower economic growth, the risky end of the corporate-debt markets has barely winced.

Some market analysts are flummoxed that the reassessment of risk, especially in emerging-market bonds and stocks, has largely ignored U.S. and European corporate debt. The resilience of poorly rated corporate debt, including so-called junk debt, which has a higher likelihood of default than does investment-grade corporate debt, has buoyed private-equity firms. They are plowing ahead with ambitious takeover plans of companies that often involve loading them up with debt.

Relative Calm

Spreads over Treasurys on U.S. high-yield and global emerging-markets bonds



Sources: Merrill Lynch; J.P. Morgan

The ability of corporate-debt markets to resist the global-market jitters underscores a thirst for returns among hedge funds and other investors. But with the Federal Reserve expected to push short-term interest rates higher from their current 5% level, that may not be true much longer as lower-risk investments become increasingly attractive.

The enthusiasm in risky corporate debt is demonstrated by the spread between the yields of safer Treasurys and corporate debt at the other end of the spectrum. Bigger yields generally reflect the risk investors are taking on. During the recent emerging-markets tumble, the spread between U.S. Treasurys and junk bonds barely budged, indicating corporate-debt investors are still unfazed by the recent gyrations in other risky investments.

"Junk spreads are the dog that did not bark," a research report from HSBC Holdings PLC notes.

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"In the past, when [short-term] rates moved up, spreads widened," said Michael Powell, head of global markets for HSBC in London. "But not this time."

At least so far. The Fed has marched short-term rates to 5% from 1% since June 2004. Despite the tightening campaign, a lot of money continues to slosh around the world looking for good investments. For now, investors are more eager to finance risky, debt-heavy private-equity deals than to buy safer Treasurys. "Lenders are still lapping up risky assets" like junk-rated bonds, said Steve Miller, head of Standard & Poor's Leveraged Commentary & Data unit. "You can't get returns on lending to investment-grade corporations."

There is so much money available to finance deals that just after the outsize **Kinder Morgan** Inc. buyout, which involved a total of about $22 billion in debt and equity, was announced at the end of May, **Bank of America** Corp.'s Banc of America Securities unit revised upward the size of companies in its list of potential candidates for buyouts. Now, the list embraces companies with a total value of $25 billion ($15 billion in debt, $10 billion in equity) in the U.S., while the comparable figure for Europe is €27.5 billion, or about $35 billion.

Today, more than half of all so-called leveraged loans, or loans for companies considered below investment grade, carry ratings of only single B. By definition, a single-B rated company has a more-than-13% change of defaulting within three years, according to S&P.

Moreover, the average debt burden on low-quality companies has steadily risen in the past few years. Today, many companies the buyout firms own carry debt loads of a fairly high eight times their earnings before interest, taxes, depreciation and amortization, or Ebitda. Private-equity firms bidding for Spanish-language media company **Univision Communications** Inc., of Los Angeles, say they are being offered financing that would permit a debt load of 12 times Ebitda as they spar over that company.

Meanwhile, the terms governing loans to debt-laden companies are increasingly generous. Some lenders are even doing away with standard loan conditions to win financing deals. Such relaxed terms reflect the intense competition to finance private-equity deals.

"There is a race to the bottom, as many banks give the issuer whatever they want," Mr. Miller said.

It isn't just banks eager to lend feeding the froth. Demand also comes from new groups of investors, including hedge funds and other money managers, who slice and dice these loans and sell them off in packages called collateralized-loan obligations or collateralized-debt obligations.

"The new technology for credit and the ability to slice and dice precisely has created more demand for credit products and new investors," said Mr. Powell. The CLO and CDO creators have taken debt that rarely traded and made it easier to trade, driving down prices and returns in the process.

"The risk appetite continues," research from Barclays Capital notes. Barclays says investors still have a huge appetite for the riskiest slices of these new structures, the so-called first-loss pieces, despite the high risk involved.

Investor demand has driven down the yield on debt from relatively lower-quality companies, thereby forcing investors seeking better returns to bid for debt from ever poorer-quality companies.

In Europe, the hunger for risk is even more extreme because the debt market has been dominated by private-equity firms issuing debt on their newly acquired companies. In recent months, such issues have accounted for 50% of all high-yield debt and 80% of so-called leveraged loans.

"Companies are already over-leveraged," said Peter Bacon, who runs the European operations for GSO Capital Partners, a New York investment firm that specializes in credit. "But issuers can bully the banks. And the pricing keeps going down because hedge-fund lenders need to put money to work and they need yield."

At some point, the current conditions will turn ugly as higher interest rates and slower growth start to pinch debt-laden companies. The wizardry that has gone into creating these new structures means there will be little warning when the turn comes. That is because one of the more popular structures, so-called PIK, or payment-in-kind, loans, allow private-equity firms to load up their portfolio companies with debt that they defer repaying.

Such back-ended structures can amount to a cynical bet that, by the time the real burden of repayment comes, the private-equity firms no longer will be the owners. Meanwhile, investors find PIKs attractive because they offer generous yields. There have been about a dozen such deals this year in the U.S. and Europe.

In addition, part of the traditional early-warning system of the debt markets comes when ailing companies ask lenders to relax loan conditions. These days, terms have become even more relaxed, or even nonexistent. Such deals have been a significant feature of the market this year, with more than $14 billion in the issues, compared with $8.4 billion in the eight prior years.

All this means that when defaults come, they will come suddenly. Moreover, recoveries are likely to be lower. That is because there are so many layers of debt, compared with previous cycles.

Also, private-equity firms have taken a lot of cash out of their portfolio companies while putting more debt on the balance sheet, leaving less for creditors when these companies finally hit the wall, said Mr. Miller.

It is tough to predict when the turn will finally happen. The smart money is starting to plan for less-robust debt markets.

"Today the environment is frothy, but we assume we will have to exit our companies in a more normal environment," Tony James, president of private-equity firm Blackstone Group said at a recent conference.

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