Monetary and financial developments

Box 4

RECENT TRENDS IN LEVERAGED BUYOUT TRANSACTIONS IN THE EURO AREA

The resurgence of mergers and acquisitions observed in the past year has been fuelled in part by a surge in private equity transactions, in particular leveraged buyout (LBO) deals. This box examines recent developments in LBO activity in the euro area and discusses potential monetary policy implications.

An LBO "consists in taking a firm private by purchasing its shares and allocating them to a concentrated ownership composed of management, a general partner, and other investors (the limited partners or LBO fund). Due to the dearth of equity of the owners, the new entity is highly leveraged." In a stylised LBO transaction a general partner, often a private equity firm, together with a number of limited partners, e.g. institutional or private investors, injects a certain amount of equity capital into an LBO fund. The LBO fund also obtains debt financing and uses the combined funds to invest in a target company. To raise the amount of debt needed to finance the takeover, the LBO fund uses the assets or future cash flows of the target firm as collateral. The return on the investment may be realised, often after a relatively short period, in various ways: an initial public offering (IPO), a trade sale (i.e. to another company), a secondary buyout by another private equity firm, or a recapitalisation (the extraction of dividends). By the time the investors realise the return, the company may be highly leveraged. Thus LBOs can affect the overall indebtedness of the non-financial corporate sector.

As the amount of own capital put into the investment by the general and limited partners is relatively small (compared with the amount of debt). The potential return on equity from an

- 1 See also the box entitled "Recent trends in merger and acquisition activity in the euro area" in the July 2006 issue of the Monthly Bulletin.
- 2 J. Tirole, *The Theory of Corporate Finance*, Princeton University Press, 2006.

Chart A The value of LBO transactions targeting euro area firms and LBO-related syndicated lending

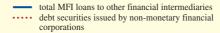
(EUR billions)

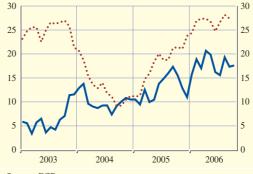


Sources: Bureau van Dijk (Zephyr) and Thomson Deals.

Chart B MFI loans to other financial intermediaries and debt securities issued by non-monetary financial corporations

(annual growth rate; percentages)





Source: ECB.

LBO investment is often substantial. Additional incentives to engage in LBO transactions are related to leverage-induced tax savings (as interest payments are often tax deductible) and the resolution of agency problems (improved managerial incentives, a more active monitoring by shareholders and the elimination of free cash flows). At the same time, LBO activity involves a risk of financial distress and eventual bankruptcy if the company's future cash flows turn out to be too low to cover the payments of the debt.³

While waves of LBO activity have frequently been observed in the United States, this type of transaction has taken off more recently in the euro area, particularly in the last two years. In the year to the third quarter of 2006, activity reached almost €80 billion (see Chart A).⁴ This development was also reflected in two-digit growth rates of MFI loans to the other financial intermediary (OFI) sector, which includes special-purpose vehicles (e.g. LBO funds) set up by private equity funds, as well as in strong issuance of debt securities by non-monetary financial corporations (see Chart B). Whereas these debt financing flows do not refer exclusively to LBO funds or private equity firms more generally, they nevertheless provide an indication of the increasing importance of LBO transactions. Furthermore, it cannot be ruled out that banks classify some LBO financing as loans to non-financial corporations, and hence LBO activity may also have contributed to the recent surge in the annual growth of loans to the non-financial corporate sector, which reached 12.9% in October 2006.

The factors underlying the recent surge in LBO activity in the euro area can be ascribed both to global trends and to euro area-specific circumstances. Among the factors of a more global nature, ample liquidity, low interest rates and default rates, and the emergence of the credit derivatives market are likely to have heightened the appetite for credit risk among non-bank financial institutions such as hedge funds and collateralised loan obligation (CLO) funds. The emergence of the credit derivatives market has also allowed banks to transfer substantial amounts of existing credit risk from their loan books, creating capacity for new lending. At the euro area level, private equity firms' incentives to undertake LBOs have been fuelled by the steady rise in corporate profitability, which has increased companies' free cash flows and therefore their attractiveness as LBO targets. In addition, the advent of the euro may have helped to create the economies of scale needed for the emergence of a high-yield bond market and other liquid, lower-quality credit instruments, such as mezzanine, second-lien and payment-in-kind (PIK) loans, which are traditionally used as subordinated debt in LBO transactions to back up senior debt in the form of bank credit facilities.

From a monetary policy perspective, it is important to monitor the rise in LBO activity as it may have implications for the overall leverage and financing conditions of the euro area corporate sector, the soundness of the banking sector and liquidity creation. First of all, the low interest rate levels driving LBO transactions may have helped mask the risks inherent in the euro area leveraged credit market. Thus, despite rising debt ratios, euro area corporate bond

- 3 See also "Financial Stability Review", ECB, December 2006.
- 4 As the coverage of the data sources used in Chart A may not be exhaustive, the value of LBOs could even be somewhat higher than the figures reported.
- 5 A CLO is a debt security backed by a pool of commercial loans. A CLO fund is an investment fund which invests in CLO products.
- 6 As the excess cash flow can be used to repay the debt raised in the LBO transaction.
- 7 A "mezzanine loan" is a hybrid of debt and equity financing. It is basically debt capital that gives the lender the rights to convert to an equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders. A "payment-in-kind (PIK) loan" is an extreme type of a loan which typically does not provide any cash flows from the borrower to the lender between the drawdown date and the maturity or refinancing date. "Second-lien loans" are used in leveraged buyouts to fill small gaps between financing needs of the borrower and maximum thresholds (measured by leverage, for example) of senior loan and or PIK loan providers.

ECONOMIC AND MONETARY DEVELOPMENTS

Monetary and financial developments

spreads remain tight by historical standards. As a result, a worsening of the corporate credit quality could lead to substantial losses on banks' credit portfolios and eventually to a more restrictive loan supply. In this regard, anecdotal evidence that leverage multiples have increased in recent LBO transactions and that loan covenants and amortisation schedules have been eased is a cause for concern. Second, while LBO transactions have often turned out to be value-enhancing (by reducing agency costs), periods of buoyant LBO activity can result in unsustainable leverage levels and too lax credit conditions. In previous episodes in the United States, this led to corporate failures and produced adverse effects on economic activity. Third, the borrowing by the acquiring entity may lead to the creation of additional liquidity to the extent that resultant payments to the existing shareholders of the target firm lead to higher money holdings.

8 See for example Kaplan and Stein, "The evolution of buyout and financial structure in the 1980s", *Quarterly Journal of Economics*, 108(3), 1993, pp. 313-357.