Capstone Project
MSc in Finance

Private Equity Backed Firms & Creditor Protection

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INTRODUCTION

The goal of this project is to identify the complex structures of private equity backed buyouts such as leveraged buyouts (LBOs) and management buyouts (MBOs) as well as to get familiarized to the debt structure involved in these acquisitions. The paper, thus, will examine the Special Purpose Vehicles (SPVs - TopCo, MidCo, BidCo) created specifically for the acquisition process as well as the debt products which are lent to those intermediate companies and are secured against the target's assets. The aim is to help IBM Global Financing to be better equipped when having a credit request from a firm who was once a target firm for a private equity fund and has undergone a PE-backed buyout. This will help facilitate the credit decision making process in terms of quality and time.

DATA & METHODOLOGY

My data are based on real life examples focusing on 1 main company – K Ltd, UK. With the help of K Ltd, which has undergone an MBO, there will be an illustration of a PE-backed acquisition structure and debt structure involved in funding the buyout. The methodology will include both qualitative and quantitative parts – with descriptive and numerical examples included.

ACQUISITION STRUCTURE OF A PRIVATE EQUITY BUYOUT

a. PE Funds

A private equity firm raises money from its limited partners including insurance companies, pension funds, university endowments, etc. General partners comprise the management of the private equity firm who, together with their investors – limited partners, form the PE fund and commit equity for acquiring/investing in chosen target companies. A PE fund's life corresponds to their investment horizon which is usually 5-7 years. It can make 10-12 investments during that period. A PE fund selects targets with potential growth opportunities in order to create value by corporate reorganization, change in management, corporate governance optimization, etc.
The consideration paid to the seller consists of very small equity contribution and debt financing which can reach 80%. Then the PE fund exits its investments typically by IPO, secondary buyout (selling off to another PE fund), trade sale.

b. Acquisition Structure[1]

Since the discussion focus is on a UK-based company and also due to the fact that PE funds are largely operating in the UK because of tax reasons, the following acquisition structure applies to the UK mainly. In a complex buyout structure, a PE fund creates 3 intermediate entities, or SPVs to acquire the chosen target firm – TopCo which is the top holding company, MidCo or a NewCo the function of which is

[1] Private Equity Demystified, Deloitte, 2017

ultimately bearing a large part of debt obtained for financing the acquisition, finally, BidCo or AcquisitionCo which becomes the immediate parent of the target company after it is acquired.
All of the equity contribution coming from the PE Fund is subscribed in the TopCo where the limited partners are considered to be majority shareholders, and the General Partners - the minority shareholders. Thus, the PE fund owns the TopCo by 100%, the TopCo owns the MidCo by 100% and MidCo, in its turn owns BidCo by 100%. These entities are created for tax and financing purposes.

With that said, assume there is a leveraged buyout and the debt involved in financing the acquisition represents senior and junior debt. The first differentiation between senior and junior debt is subordination. There are 2 types of subordination – contractual and structural. Contractual subordination is about the different priority claims on repayment of the senior and junior debts. Structural subordination is when the senior creditor lends to a company which is lower in the group structure than the company to which the junior creditor lends[2]. Now, the acquisition structure of the 3 SPVs created specifically for PE-backed buyout purposes is justified through structural subordination. This means that BidCo which is the lowest in the group structure, will receive senior debt financing from outside lenders. MidCo will receive junior debt, and Topco will have the equity portion possibly along with riskier types of junior debt. To illustrate, in case of liquidation of the target company, the first creditor to be repaid is the senior creditor. Thus, the target company will pay its immediate parent BidCo which will repay its senior creditor. Once, the senior creditor is fully paid, only then the junior debt will be paid down. This means that Midco will be next to pay down the junior creditor before any distribution is made to the shareholders in TopCo.

DEBT STRUCTURE OF A PE-BACKED BUYOUT

There are 2 main categories of debt involved here – senior and junior (high yield or subordinated) debt. Senior debt includes second lien debt; revolving credit facilities; senior term debt and tranches of a term loan. Junior debt includes mezzanine debt; PIK notes; PIK Toggles; PIK options on second lien debt, mezzanine debt; preferred shares; convertible preferred shares; convertible debentures.

c. Senior Debt

   i. Typically, senior debt can represent up to 50% of a PE-backed buyout equating to 2-5x EBITDA or 2x interest coverage ratio of the target. It is usually secured with the assets of the target and has the 1st claim/lien to the cash flows of it in case of liquidation and thus has the lowest interest rates. It is generally issued with floating interest rate of LIBOR + 200-400bps for a period of 7-10 years and stipulates covenants on the business to meet certain performance criteria. Importantly, senior debt has a mandatory amortization schedule while junior debt does not.

   ii. Second Lien Debt

Second Lien Debt is a form of senior debt but has the 2nd priority claim to the target's assets in case of liquidation. Second Lien creditor is paid down only after the 1st lien senior lenders and before the junior lenders get paid. Interestingly, first lien and second lien lenders can have claims on the same assets and, in

[2] https://uk.practicallaw.thomsonreuters.com/3-107-7332?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1

case of liquidation, will share the recovery amounts either pari passu or according to an agreed ratio[3]. Second lien debt, however, has some features that are common to junior debt. For example, second lien debt can have PIK options, can have full, little or no amortization.

iii. Recent Developments in the Second Lien Debt Market

The issuance of second lien debt in 2017 has more than doubled the 2016 total volume and LBOs were the largest driver of this volume growth[4]. This is changing the capital structure of PE-backed buyouts. For example, in the combination of a first-lien loan, an unsecured bond, and an equity contribution from the acquiring PE firm, the unsecured bond piece has been largely replaced by the second lien debt. This change is driven by several features of the latter. The first is the favorable call profile of the second lien loan. Its call premium is significantly lower than that of a bond and has a shorter time frame to call. This gives the PE firm substantially more flexibility to refinance the second lien debt if necessary. In addition, the issue process for high yield bonds and second lien loans is another factor to count as a reason in the recent changes for this market. Usually, in an LBO, high yield bonds and second lien loans are going through a syndication process. While issuing bonds can take a couple of days following a standardized template with limited financial information, the issuance of second lien loan can take weeks during which the potential investors receive remarkably more information including historical and projected performance as well as gain better access to company management.

However, there are also downsides to the second lien loan market. Trading of second lien loans is not as fast as that of a bond. While a bond can settle in T+ 2, the trade settlement for second lien loans can take weeks, again. Fewer investors are involved in the second lien market due to the long due diligence and settlement days. This greatly decreases the liquidity of the market. Second lien debt has higher yields than unsecured bonds as a compensation for the lack of liquidity and call protection.

DDJ Capital Management notifies that it expects the use of second lien debt rather than unsecured bonds to finance LBO transactions to continue and possibly increase in the near future[5].

d. Junior Debt

i. Mezzanine Debt is a unique type of junior debt that has equity component of 10-15%. It is senior in repayment priority to equity but is subordinated to senior debt in case of liquidation. There is minimal due diligence on the borrower when a mezzanine debt is issued. This increases accessibility to mezzanine market providing additional sources of liquidity. It has a series of advantages to the borrower: there is no collateral required for mezzanine debt as due to its equity portion, it is viewed as more like an equity security. Mezzanine debt does not require immediate principal amortization, hence, offers flexibility to the borrower to service its cash for other business purposes.
When a potential creditor sees mezzanine debt on the financials of its credit requestor, equity is viewed as enlarged by the equity component in the mezzanine debt, thus, giving the requestor more credibility. However, because mezzanine debt can start amortizing from the 3rd or 4th year of lending, it is a riskier investment for the creditor. Minimal due diligence and the absence of collateral magnify the default probabilities.

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[3] Neil Cummings and Kirk A. Davenport, *"A Primer on Second Lien Term Loan Financings"*
[4] DDJ Capital Management, LLC – "Second-Lien Loans: Increased Use in LBO Financing"
[5] For as long as the demand for second lien loans persist and their call protection remains more favorable

ii. Payment In Kind or PIK notes are the other debt type in the focus of this paper. These are deeply subordinated ranking just before the equity in case of liquidation. Payment In Kind means the interest payment on a loan is in a form other than cash. The borrower can issue additional debt instead of paying interest in cash. Another means is to defer the interest payment which is added to the principal amount. Hence, the interest payment of the following year will be calculated on the new and larger amount of principal. There are 3 types of PIK notes – True/Mandatory PIK, PIK Toggle, Pay If You Can. With the first type, the debtor is required to pay exclusively in kind or by a combination of cash plus in kind interest. The PIK Toggle notes give the issuer the discretion to pay interest either in cash, in kind or in a combination of the two. The 3rd type is paid in kind only if certain covenants are breached, otherwise, if you can – you should pay interest in cash.

EVERYTHING IN ACTION

K Ltd, based in the UK, requests a base credit line of a certain amount from IBM Global Financing. The financials of the company show good profitability, growth of about 20%, increasing margins, and the financial position appears to be very strong with almost 19% growth in the equity, no financial debt, increased cash balance, good liquidity and solvency. IGF then conditionally approves the request, the condition being an insurance coverage. The insurance company, however, comes with a rejection to cover such a request revealing the group structure of which K Ltd was a part. It turns out, that K Ltd is backed by a PE Fund and in between there are the following entities - TopCo, MidCo and BidCo. The reason of their rejection was due to the financials of the TopCo holding company which had enormous amounts of both long-term and short-term financial debt totaling around GBP 80M. Moreover, the TopCo was loss making and had negative equity and tangible net worth.
In the table below, you will find similar debt structure to K Ltd's Holding company:

Tranche of Debt	Carrying Amount	Principal amount	Year of final maturity	Nominal Interest rate	Cash Paid Rate	Payment In Kind
Series A1 Notes (GBP)	£13 590 000	£16 444 000	2020	LIBOR	5,25%	-
Series A2 Notes (EUR)	£6 787 000	£6 776 000	2020	EURIBOR	5,25%	-
Series B1 Notes (GBP)	£5 087 000	£4 776 000	2020	-	10%	3%
Series B2 Notes (EUR)	£3 509 000	£3 222 000	2020	-	10%	3%
Shareholder loan notes	£16 986 000	£13 481 000	2022	-	-	8%
Related Party loan notes	£11 687 000	£8 975 200	2022	-	-	8%
	£57 646 000	**£53 674 200**				

No disclosure of what each series represented but more important is for the creditor to be able to identify those. For example, Series A1 and A2 represent 2 tranches of senior debt issued in different currencies. You can tell those are senior tranches due to the nominal and cash paid rates, and the obvious amortization of the principal amount. With series B1 and B2, it is tricky to identify whether those are second lien debt or junior debt because they share common features in this particular set-up. You can see PIK option of 3% on the debt and much higher interest rate. What is more, the principal amount is not decreasing or, in other words, is not being amortized due to payments in kind.

Still, if a creditor viewing this table wants to know its repayment priority in case of liquidation, further information can be requested from the potential borrower to specify the tranche B whether it is a second lien or junior debt. Shareholder loan notes, which are usually issued to the PE Fund, are very risky in this debt structure. It is because of the highest interest on the PIK and due to the fact that the interest payments are paid solely in kind (True PIK). You can observe the carrying amount (at 2016) increasing dramatically since the principal was issued (2014).

The PE Funds' investments become profitable not only due to the value they create in the target firm, but due to the leverage they use to fund the acquisition. The high leverage provides with an enormous tax shield. Just like in case of the Boots Alliance buyout by the U.S. private equity giant KKR where the acquisition amounted to GBP 11.1B out of which GBP 9.02B was debt financing. The latter decreased the taxable income of the target firm by GBP 4.2B resulting in tax avoidance of about GBP 1.1B[6]. Leverage increases the investment returns of the private equity not only through tax shield. We have just seen in the above table how much the principal amount increases due to the PIK options on debt, in this case, shareholder debt. Thus, when exiting, or when it comes due, the PE Fund receives high returns on those notes as well.

CONCLUSION

It is important to perform a hierarchy check on a credit requestor, and in case if there has been a private equity backing the buyout of the requestor, IGF will now know what entities to look for in the acquisition scheme, the reason they are there and what types of debt may have been included in the buyout along with the risks associated with each of them. This will help make better-informed decisions for companies which have once undergone a PE-backed buyout.

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