The Mega LBO Frenzy

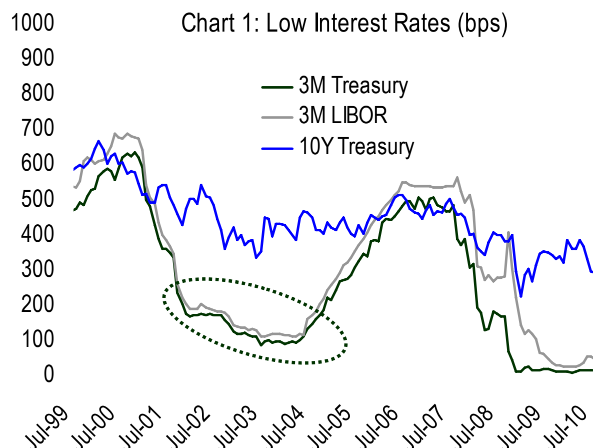
HOTCHKIS AND WILEY CAPITAL MANAGEMENT

High Yield Newsletter August 2010

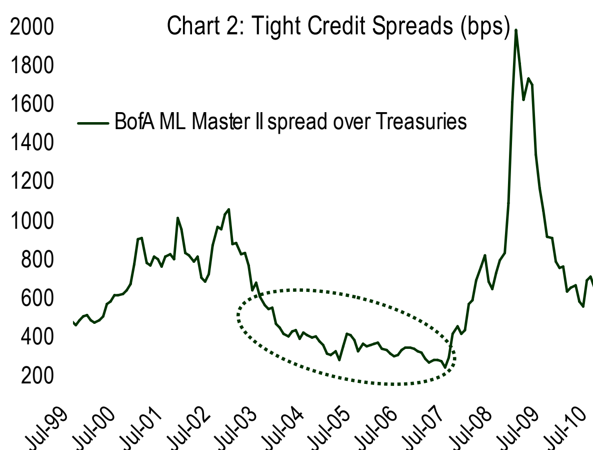
"Creditors have better memories than debtors"
Benjamin Franklin (1706 – 1790)

Introduction

Three long years ago, the high yield market's worst calendar year had been its -5% return in 2000—the -26% return in 2008 eclipsed this mark fivefold. Credit markets have recovered admirably since the depths of late 2008/early 2009, and we appear to have returned to a pseudo-normal environment. Memories of 2008 have left investors jaded; however, and fear that the dreadful year could recur continues to weigh on investors.



With the storm passed, we believe it is an opportune time to revisit the primary culprits, including the leveraged buyout (LBO) craze in the mid-2000s, which led to the market's 2008 collapse. More significantly, we will comment on what we have learned from this precarious period. This newsletter will begin with a historical synopsis of the events leading up to 2008 and will end with our observations of what has changed since. ***Notwithstanding the benefit of hindsight, we believe credit markets exhibited clear signs of danger and prudent high yield investors could have skirted the worst of it.***

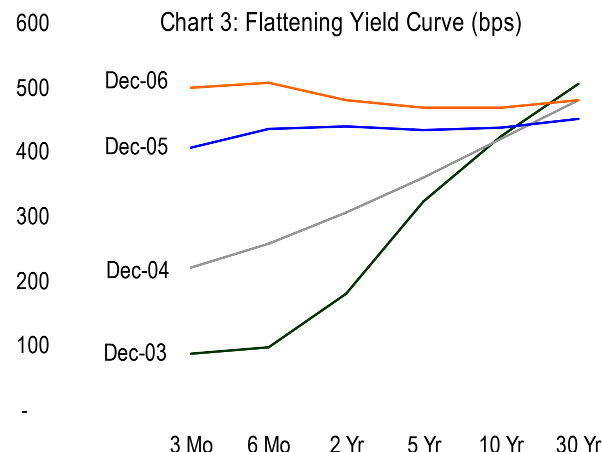


Low Interest Rates, Tight Spreads, and a Flat Yield Curve

"I'm living so far beyond my income that we may almost be said to be living apart."
- E. E. Cummings (1894 – 1962)

The Federal Reserve cut its Fed Funds rate target from 6.5% in 2000 to 1.0% by mid-2003. Consequently, Treasury yields and LIBOR declined. Also, high yield spreads over Treasuries and bank debt spreads over LIBOR both tightened considerably (Treasuries are the primary interest rate benchmark for high yield issuers and LIBOR is the primary interest rate benchmark for bank debt). The Federal Reserve finally began to re-raise its Fed Funds target rate in mid-2004. While this caused short-term rates to rise, medium/long-term rates continued to decline until the yield curve eventually inverted in 2006. Low interest rates and a flat yield curve create an attractive environment for borrowers/issuers…and many borrowed—excessively.

Low Interest Rates
\+ Tight Credit Spreads
\+ Flat Yield Curve
= Borrower Euphoria



The LBO Frenzy Begins

"Opportunity may knock only once, but temptation leans on the doorbell."
- Unknown

Easily-accessible and inexpensive credit enticed private equity companies to embark on a LBO boom unlike any other. A new regulatory burden for public companies (Sarbanes-Oxley) added to privatization incentives. In 2006, private equity firms raised a record $255 billion in new capital. In 2007, they raised $302 billion[a].

Characteristics of the "Golden Age" LBOs

"Excess on occasion is exhilarating. It prevents moderation from acquiring the deadening effect of a habit."
- William Somerset Maugham (1874 – 1965)

It was not the mounting number of LBOs during this era that provided the key warning sign for investors to use caution; it was the underlying characteristics of the LBOs. Three previously-rare traits were commonplace among LBOs during this period:

- Colossal deal size
- Bank debt-laden capital structures
- Excessive flexibility for debtors

Colossal deal size

Prior to the mid-2000s large leveraged buyouts, like the frequently-studied RJR Nabisco deal, were rare. Conventional wisdom had been a $5 billion maximum amount that could get refinanced. There were no deals greater than $5 billion in 2000, 2001, 2002, or 2003. In 2004 there were two deals that exceeded $5 billion. Then, from 2005 to 2008, there were 75 LBOs in excess of $5 billion. Fourteen of the largest fifteen LBOs in history were announced in 2006 or 2007[b].

Chart 4: Largest LBOs in History

Size	Name	Year
$43B	Texas Energy Future (TXU)	2007
$34B	Equity Office Properties	2006
$32B	HCA	2006
$30B	RJR Nabisco	1988
$27B	First Data	2007
$27B	Kinder Morgan	2006
$27B	BAA Airports	2006
$27B	Harrah's Entertainment	2006
$27B	Alltel	2007
$26B	Hilton Hotels	2007
$25B	Clear Channel Communications	2006
$23B	Alliance Boots	2007
$20B	Archstone-Smith	2007
$16B	Intelsat	2007
$16B	Freescale Semiconductor	2006

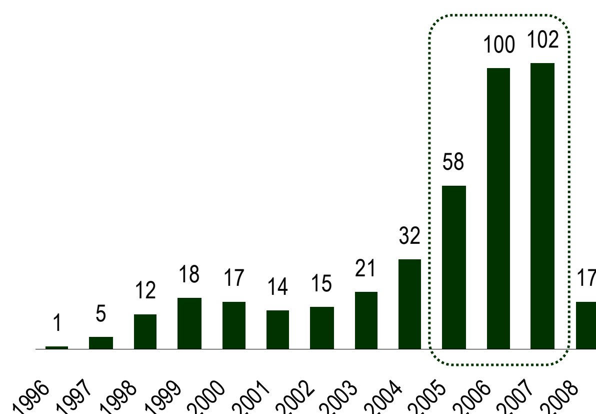
Bank debt-laden capital structures

The low interest rate environment caused investors to seek additional yield in new areas—enter collateralized debt obligations (CDOs). CDOs are asset-backed securities whose collateral is composed of a portfolio of fixed income assets (e.g. bonds). The objective of a CDO is to allow the underlying assets to be sold in various tranches, each with varying risk/return profiles. The most senior tranche gets paid first but has the lowest yield, and vice versa—akin to mortgage-backed securities.

A specific type of CDO, a collateralized loan obligation (CLO), is backed by bank loans. A bank makes a loan to a company in return for interest and principal payments. The CLO essentially buys the loan from the bank (i.e. takes the bank's position). The bank earns a fee and removes counterparty risk, which has now been assumed by the CLO owners. This risk is then sold in various tranches from senior (lower yield) to junior (higher yield). The CLO market effectively increases the supply of creditors willing to lend to businesses. Because banks were able to make loans and sell them shortly thereafter (after earning a spread, of course), they were willing to make more loans.

The demand for additional yield by way of CLOs exploded, driving up the demand for bank debt and putting downward pressure on interest rates. To boost yield further, a growing number of CLO managers employed leverage, which in select cases topped 10x (they were leveraging leveraged loans). CLO mangers were like Pac-Man, trying to eat up any and all loans they came across.

Chart 5: New CLO Volume ($ Billions)



Prior to the mega-LBO era, the conventional wisdom had been that bank debt should not represent more than 50% of LBO financing. Dynamics of the era changed this dramatically. Bank debt *averaged* 63% of LBO financing during the period. Three-quarters of the largest LBOs of the era were financed with more than 50% bank debt and one-third were financed with more than 75% bank debt[c]. This not only weakened the recovery potential for bondholders in a distressed situation, but also increased refinancing risk significantly.

Excessive flexibility for debtors

Periods of loose credit are typically defined by low interest rates and covenant-light loans. This period epitomized these attributes. Additionally, PIK/Toggle notes became the standard (PIK: pay in-kind). These instruments allow the debtor, at their sole discretion, to make interest payments in-kind rather than in cash ("in-kind" means the borrower makes its payment using additional debt). Should the borrower choose to pay in-kind, the effective interest rate would increase, usually 50-100 basis points. This creates an incentive for borrowers to pay cash when possible. Nevertheless, cynics referred to these loans as having a "pay if you want" structure. At the time, investors were often forced to agree to the PIK/Toggle structure in order to get a full trade allocation. More than half of the largest LBOs of the era were PIK/Toggle notes[d].

Performance of the LBOs

While we did not conduct a comprehensive scientific study, we examined the performance of some of the largest LBOs of the era and compared it to the overall high yield market. The results were mixed. Thirteen of twenty large LBOs outperformed the Index by an average of 2.1% annualized; the remaining seven LBOs underperformed the Index by an average of 5.0% annualized. Interestingly, it was the mega-LBOs that underperformed. There were seven deals greater than $15 billion—six underperformed by an average of 5.7% annualized.

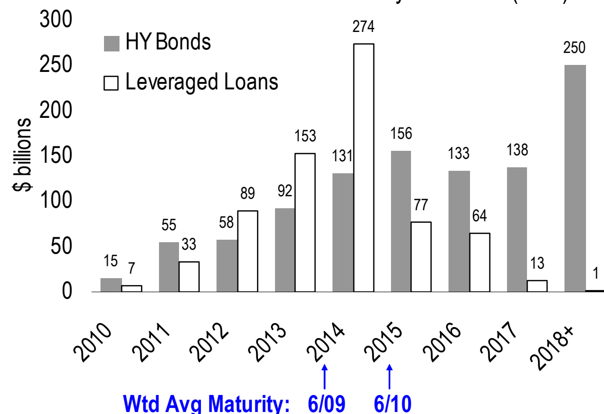
Most managers aspire to outperform their Index by 100 basis points or more, after fees. Most of the bonds issued by this sample of the largest LBOs failed to meet this hurdle. More significantly, the wide range in performance highlights that credit selection is paramount. Many large funds are faced with unruly pressures to invest in short order making this critical task challenging.

The LBO Aftermath: Lessons Learned

"I'm not the man I used to be, so why should I have to pay off his debts?"
- Gary Apple

The confluence of yield-chasing investors, low interest rates, low spreads, and excessive leverage unleashed a perfect storm in late 2007/early 2008. While the economic downturn was the primary culprit for financial underperformance, the leverage many companies employed caused their bonds to perform poorly. Excessive leverage can paralyze a company because it prevents reinvestment in its business and consequently weakens its competitive position.

Default rates peaked around 12% in mid-2009 (17% including distressed exchanges)[e]. Had it not been for aggressive interest rate cuts by the Federal Reserve and aggressive support from governments across the world, default rates would have been even higher. The lower interest rates saved bank debt-laden companies highly coveted cash. Also, a rapid capital markets recovery enabled refinancing, which extended debt maturities and delayed the day of reckoning.



Ironically, the extreme flexibility debtors enjoyed probably prevented a number of defaults. While abhorrent to traditional credit investors, PIK/Toggle loans enabled companies to kick-the-can-down-the-road long enough to recover. TXU and HCA are notable LBOs that exercised their PIK option and saved hundreds of millions in cashflow, which improved their liquidity and eventually permitted them to refinance.

Wrap-Up

At times, it is inevitable that credit standards deteriorate and investors seek additional yield in all the wrong places. Thankfully, periods of extreme excess are infrequent. The convergence of events feeding the mid-2000s LBO frenzy is unlikely to repeat any time soon. If history is any guide, the next steroid-fed LBO cycle is at least a decade away from now.

In the event the cycle resurfaces earlier, we will be best served to stick to our guns by constructing a portfolio that is conservative relative to the market and avoid these types of credit events. ***Rigorous research centered on asset coverage, cash flow stability, and companies/industries with discernable competitive advantages forms a margin of safety for high yield investors. Haphazardly boosting yield backfires more often than not—avoiding the losers is what pays off time and again***.

Mark Hudoff and Ray Kennedy
Hotchkis and Wiley High Yield Portfolio Managers

Past performance is no guarantee of future results. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Credit cycles vary in both length and volatility. Past credit cycles will differ from current or future cycles.

[a]Reuters
[b-d]Bloomberg
[e]JPMorgan
Sources: (Data as of July 31, 2010 unless otherwise noted)
Charts 1-4: Bloomberg
Chart 5: Credit Suisse, Moody's, S&P and Fitch
Chart 6: JPMorgan using data from Markit, which provides an independent service enabling subscribers to benefit from daily composite and individual contributor level pricing on bonds and leveraged loans.

The BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade, but not in default, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.

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