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## Rating Private Equity Transactions

The current environment of significant private equity deal volume, along with the very large size of some transactions, highlights concerns for Moody's analysts regarding the review of private equity sponsored transactions. While much transformation activity continues, creditors are not participating in the potential "upside" available to private equity firms or original shareholders. Future performance of current transactions will likely hinge on the economy remaining relatively stable and the credit markets remaining forgiving as many of these transactions will need to be re-financed over the coming years.

Under these conditions, Moody's:

- is skeptical that stated plans to de-leverage or exit via the IPO market will actually be carried out given current market conditions which provide ample opportunities for dividend distributions;
- will continue to factor in the characteristics of an industry when evaluating the risk of high leverage, as well as opportunities for cost reductions and operational improvements, but notes that many recent leveraged buyouts ("LBOs") are in industries with high capital requirements, competition, or cyclicity, increasing risk;
- has seen the equity component of private equity owned issuers diminish, making valuation more of a challenge, particularly as private equity firms increase dividend activity, sometimes completely eliminating the amount of contributed capital in their investments;
- is concerned that debt holders have less rights given the prevalence of no or minimal financial maintenance covenants and modest amortization requirements among current transactions.

### Overview

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This comment explores the role of private equity in highly leveraged transactions and the analytical considerations for corporate family ratings of private equity owned issuers.

## Private Equity – Fact versus Theory

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Private equity firms' investments comprise a meaningful proportion of the overall high-yield universe. They are an even higher proportion of the single-B issuer universe. The Moody's study, "Default and Migration Rates for Private Equity Sponsored Issues," November 2006, found that of the speculative grade companies rated by Moody's between 1987 through 2005, 20% became sponsor deals at some point and 15% were always sponsored, while 65% of the companies were never owned by a sponsor firm. In all likelihood, a greater proportion of the high-yield universe is sponsor-backed today than ever before. Leveraged buyouts, measured by new bond issuance, comprised 18% by the beginning of 2007 versus about 5% between 2003 and 2004. The Moody's study also concluded that sponsor-backed firms default more frequently than does the overall speculative grade universe of firms because they predominantly operate in the single-B range.

LBO theory is based on the expectation that the benefits of leverage are twofold: it creates discipline within the corporate organization and it provides higher returns for the private equity firm. It is also frequently argued that the benefits of becoming a private company allow the management team to invest over a longer time horizon, unburdened by the demands of short-term focused public shareholders and without the expenses associated with public reporting requirements (i.e. Sarbanes Oxley and the like). Additionally, private equity firms assert that they have a unique ability to obtain good managers for their investments, a claim based mostly on their willingness to provide exceptional rewards for strong performance but also on their good relationships with business leaders. Moody's notes a study, "Private Equity Performance: Returns, Persistence and Capital Flows" by Steve Kaplan and Antoinette Schoar, concluded that a private equity firm's ability to raise new funds correlates with stronger private equity performance. Thus, many of the largest funds in the market today should have a history of better than average performance.

While Moody's would agree that leverage is likely to impose discipline and provide higher equity returns, the current environment does not suggest that private equity firms are investing over a longer term horizon than do public companies, despite not being driven by the pressure to publicly report quarterly earnings. We also question whether there is sufficient evidence to prove that the higher returns provided to private equity are driven by stronger management teams or because, in a benign and liquid credit environment, leverage by itself can provide substantial returns to shareholders. Moreover, many private equity firms pay themselves annual management fees as well as investment banking fees (for acquisitions, for example), increasing returns to the private equity firm. As a consequence, a rating committee reviewing a private equity transaction will focus on the ability of a firm to support the new, highly leveraged capital structure. In addition, analysts should deduct management fees from cash flow despite it rarely being presented this way. We are less optimistic about the willingness of the private equity firms to inject capital in the future, if necessary, at a rate different from that of a strategic owner/operator would. In fact, there are circumstances in which we think that private equity would have less incentive to do so.

It is likely that the credit impact from private equity transactions will be more ambiguous going forward. Much private equity capital has been raised and needs to be invested. We note that generous levels of market liquidity driven, at least in part, by the unusually low level of defaults (near 12 year low as of June 2007) have led to investors showing less discrimination regarding credit quality, as evidenced by the increase in very low rated debt being issued on generous terms. The prevalence of dividend distributions has fueled a meaningful portion of this capital raised. Of concern to Moody's is the willingness of private equity firms to issue special dividends despite commitments to reduce leverage, sometimes within 12 months of the transaction's closing.

### For Example:

- WideOpenWest (sponsor firm, Avista Capital Partners) and San Juan Cable (sponsor firm, MidOcean Partners) were both downgraded to B3 from B2 during the first quarter of 2007 following unanticipated dividends within 18 months of the original equity contribution. Avista's dividend was greater than twice the size of the company's initial equity contribution.
- Deluxe Entertainment Services (sponsor firm, MacAndrews and Forbes Holdings Inc.) was purchased in January of 2006. In May 2007, the company made a dividend distribution in excess of the original equity investment.
- In December 2004, WMG Holdings Corp, an LBO of the music subsidiary of Time Warner Inc. (sponsor firms, Music Capital, Thomas H. Lee, Bain Capital and Providence Equity) made a distribution which removed substantially all of the equity originally committed by the sponsors. This distribution occurred within the first year of operations despite public comments made by the company to the contrary.
- During 2004, Celanese US Holdings was downgraded to B1 from Ba3 after issuing additional operating company subordinated debt to fund repayments of holding company PIK notes held by its sponsor, Blackstone Group, one month after completion of the initial transaction. Three months later, the company issued holding company notes to fund a dividend that removed over 95% of the cash equity originally contributed. At the time of the initial rating, Blackstone communicated to Moody's that the exit strategy was an IPO within 18 months so there would be no need for special dividends.
- In January of 2004 and within 4 months of Nalco Company's initial rating, the company's sponsors (Blackstone Group, Apollo Management and Goldman Sachs Capital Partners) issued holding company notes in order to provide distribution of roughly half of the initial cash equity.

The reason for the dividends – whether pressure to increase returns, because the market's liquidity allows for such transactions, or something else – is not always apparent. Future performance of many of these transactions will likely hinge on the economy remaining relatively stable and the credit markets remaining forgiving as these transactions will need to be re-financed over the coming years.

## Private Equity's Lack of Transparency

Some of Moody's credit concerns regarding sponsored transactions are unlikely to be resolved because they arise from the lack of transparency typical of private equity firms. For example, in Moody's view, a sponsor's equity contribution in a leveraged transaction (LBO or acquisition) may not necessarily become a permanent part of the company's capital structure. We note that the amount of capital contributed tends to fluctuate at least in part because of several exogenous factors that analysts have little ability to measure:

- the financial needs of the overall fund of which this investment is one part, and
- the relative liquidity of the capital markets and opportunistic financing offered the firm.

Moreover, we believe underperformance by a particular issuer in a private equity firm's portfolio can impact other issuers in the fund. If deterioration at one investment constrains a return of capital, it puts additional pressure on other firms in the portfolio to compensate.

As a result and despite certain strengths that sponsors often contribute (i.e. management depth, sophistication, access to capital) Moody's remains cautious of the merits of private equity capital contributions, although corporate family ratings to date generally reflect the impact of the equity component of a transaction. However, while companies often commit to de-levering, execution is not consistent.

If in the past Moody's did assume that a private equity firm's exit strategy would be the IPO market or sale to a strategic operator, this is no longer the case. In times when the IPO market is less receptive or the credit market particularly generous, issuers have re-levered and returned capital with "one-time" (although potentially several) dividends. However, we do believe it is more likely that the larger the equity investment, particularly versus other same-fund investments, the more motivated the private equity firm to insure the overall success of the company.

### For example:

- Marquee Holdings, Inc. committed to de-lever following the merger of AMC (Marquee subsidiary) with Loews Cineplex. However, when the company's planned IPO was suspended in May of 2007, the company increased leverage instead by providing a \$675 million special dividend to its sponsors, including JPMorgan Capital Partners, Apollo Management, BainCapital, Carlyle Group and Spectrum Equity Investors.
- In July 2004, Hexion Specialty Chemicals, Inc. stated that its financial strategy would include debt repayment, notwithstanding the debt continued to increase due to acquisitions and special dividends. Originally contributing \$204 million of equity in July 2004, Hexion then went on to provide a \$550 million merger dividend in May 2005 and a subsequent \$500 million dividend in October of 2006 after a failed IPO.

## Moody's Key Credit Concerns for Private Equity Transactions

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There are several elements of private equity sponsored transactions that are addressed as a part of our credit considerations during committee:

- Percent of common equity contributed at inception
- Potential for future equity distributions
- Thesis for de-leveraging:
  - cost reduction,
  - improving operations,
  - organic growth
- Private equity and management track record and expertise
  - Management fees – presence and magnitude
- Valuation
- Exit strategy/time frame
- Level of disclosure and transparency of organizational structure
- Complexity of capital structure
  - Types of securities issued (preferred, toggle notes, etc.)

## Leveraging the Firm

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Moody's speculative grade corporate family ratings will be higher in situations where increasing levels of leverage are balanced out by some key mitigating factor such as: sector stability or growth, non-cyclical or non-capital intensive industry, future IPO opportunity, long term contracts, etc. Moody's analysts tend to be more circumspect where industries are cyclical, in decline, or volatile, and thus where projections in the industry are less reliable. We regularly review LBO issuers with meaningful capital requirements (industrial, cable), limited sale/IPO opportunities (CLECs), and in highly competitive and cyclical or volatile operating environments (technology, music, etc.).

In general, when Moody's is evaluating the benefits of an LBO, we consider the potential cost reductions and operational improvements although we are sensitive to circumstances where restructuring charges seem to be ongoing. Alternatively, we often see the benefit of a divestiture from a large corporate entity and recognize the opportunity to take private an under-managed subsidiary where at a minimum corporate expenses can be removed. We also remain open minded regarding transactions with issuer-specific advantages such as real estate opportunities in the retail sector (i.e. ToysRUs). However, we remain mindful that the ultimate beneficiary of these advantages may be the private equity firm.

## Management Strength

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We attribute credit to an equity firm's expertise unless it is offset by aggressive financial risk taking. Mostly this is because a private equity firm is usually quick to fire ongoing management and hire new people to manage the operations if goals are not being met. In addition, private equity has become a very compelling opportunity for motivated executives looking for significant pay packages linked to performance.

## Equity Valuation

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In the high-yield credit environment and particularly for single-B credits, Moody's analysts consider valuation a key part of their overall analysis. For private companies, valuation is inevitably more challenging. Analysts are forced to rely more heavily on information from the firms themselves. Notwithstanding the large number of transactions, valuations have become more volatile recently as private equity firms increase dividend activity and reduce the amount of common equity in their investments. It seems reasonable to assume that firms that have already made an attractive return on their investment may consider increasing the financial risk associated with that issuer. We have seen examples where a private equity firm has effectively repaid its entire investment as well as additional dividends and management fees over a very short time horizon (3 years or less) including Deluxe Entertainment (1.5 years), WideOpenWest (1 year), Warner Music (less than 1 year), etc. Therefore we may assume there is additional risk through excessive leverage in part because the private equity firm's downside has significantly diminished.

## Exit Strategy

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While recent activity in the marketplace supports Moody's premise that equity sponsor capital is not permanent, some equity firms are floating their investments and yet continue to retain a meaningful ownership position. These firms have, as a matter of course, more disclosure and potentially less volatility given the reporting requirements associated with operating a public company. Their dividend policy has become more explicit and there is less uncertainty. The ratings on these companies are likely to stabilize.

Alternatively, certain industries do not lend themselves to the public market and it is these firms that Moody's expects will continue to operate privately and generate returns for the owners through capital distributions, for example small, niche players. These firms are more likely to see their ratings constrained by anticipated returns of capital. In other words, de-leveraging is expected to be offset by dividends and private share repurchases. For example, this phenomenon is highlighted in the CLEC sector. (Please refer to "US-Based CLECs: The Outlook for Continued Success", October 2006.)

## Current Market Liquidity and Opportunistic Financing

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In the current credit environment, Moody's has witnessed a proliferation of all-bank transaction structures - albeit frequently including first and second lien loans. In our view, this could lead to increased vulnerability to expanding interest costs and weaker debt service metrics as interest rates inevitably rise. Therefore, Moody's is looking for a high degree of hedging on the part of issuers so that a reasonable proportion of a company's debt is fixed.

Please refer to "Refunding Risk and Needs for U.S. Corporate Speculative Grade Issuers, 2007 - 2009, February 2007" for more information regarding refinancing risk within the speculative grade universe.

## Key Safeguards Provided by Credit Agreements and Bond Indentures

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Within the credit agreement there are several means to enhance creditor protection from some of the inherent conflicts with private equity firms. Notably, recent bank transactions have had a diminishing amount of protection, potentially also affecting bondholders who may have historically relied on bank covenants to restrain aggressive behavior by issuers/sponsor firms. In the past, credit agreements included standard financial maintenance covenants and cash flow sweeps in speculative grade transactions, debt repayment from asset proceeds took precedence over capital distributions, and firms occasionally committed to capital calls when the business plan was subject to a high degree of uncertainty.

In Moody's view, bond indentures that provide reasonable protection would be expected to include covenants limiting debt incurrence, restricted payments, and change of control at a minimum.

(For more details please refer to "Moody's Approach to Evaluating Indenture Covenants and Assigning Covenant Quality Assessments, November 2006").

## Related Research

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### **Special Comments:**

[LBO Risk Alert: Buyouts Take Toll on Technology Ratings, June 2007 \(103331\)](#)

[Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies, June 2007 \(103433\)](#)

[Specialty Retail 2006 Trend Report: High Leverage is IN Cash is OUT, January 2007 \(101837\)](#)

[Default and Migration Rates for Private Equity-Sponsored Issuers, November 2006 \(100799\)](#)

[Moody's Approach to Evaluating Indenture Covenants and Assigning Covenant Quality Assessments, November 2006 \(100768\)](#)

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