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**ARAOZ & RUEDA****Is the sub-prime mortgage crisis  
affecting the buyout market?**

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**A**fter the bursting of the tech bubble in Y2K, which saw stock prices decline 40% and threatened to pull the economy into recession, the combination of low interest rates, depressed equity prices and rising corporate profits created ideal conditions for private equity firms to flourish (in 2002 buyout prices averaged just 5x EBITDA).

In the last years, PE firms have been raising new funds. The targets are bigger than ever and deals have become more complex and riskier. This is true. But we can not ignore that borrowed money is the real fuel driving an overheated market. The excess of liquidity has created some mispricing in the credit markets. Because the scale of the private equity deals has been so big, banks have generally believed they could not afford not to take part in them. There was a feeling that if they did not participate, then someone else would.

The amount of credit that lenders have agreed to grant to private equity transactions has risen substantially.

Competition for deals and low cost of debt bumped up the size of the loan relative to the equity. Paying higher prices meant borrowing more money; as debt levels grew, interest payments absorbed a bigger portion of cash flow, eliminating the margin of safety that made the earlier deals so compelling.

Although the US subprime mortgage market is unrelated to the buyout financing, suddenly lenders seem to begin facing up to the risks they have been taking. Clearly, the rising defaults in that mortgage market seem to be just an excuse for lenders in buyout deals to stop for a thought:

From a worldwide perspective, debt markets that finance private equity transactions had changed in three important ways: they were charging lower interest rates, they were lending more money for the purchase of target companies, and they were reducing or virtually eliminating covenants and other rules that made it almost impossible for private equity investors to default on loans used to buy companies, mainly in big private equity transactions. They also often allowed companies to borrow more money to pay interest, a feature in many deals, that resembles the negative-amortization home loans (which allow homeowners to add unpaid interest to the principal) that juiced the mortgage market. In certain markets, a relatively new phrase, "covenant lite" has become popular to describe these lending terms in big private equity transactions.

Banks justified granting bigger loans because they gave more consideration on how quickly they could offload the debt by selling on portions to other banks rather than on the ability of their client to repay the money. On another hand, private equity executives have been taking as much as they can get from debt markets, but still raise the issue of lending excess in public because it could be bad for business eventually. This practice has driven up the prices of companies they buy and hurt future investment returns in case of a change of cycle.

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In my opinion, although we can not say we are in a bubble, as in the dot com times, there will be declines. It took PE firms five years to recover from the fund raising excesses of Y2K. That correction was precipitated by the collapse of the Internet bubble and it was very painful. Certainly, there are substantial differences with the situation preceding the Internet bubble. PE firms have now invested in companies with real revenues and profits and their deals have a much higher liquidation value. The possibility of complete loss of value is highly unlikely. Furthermore, target companies going public usually present cleaner and more efficient businesses for investors to invest in than in the dot com times (probably, because they have attracted top level managers to run the companies). Last but not least, funds are now in better shape to commit extra money to shore up a failing company while target companies are better equitised, with larger cash commitments from private equity investors.

Being optimistic by nature, what we will probably see in the next months is simply a bit of sanity returning to the market.

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