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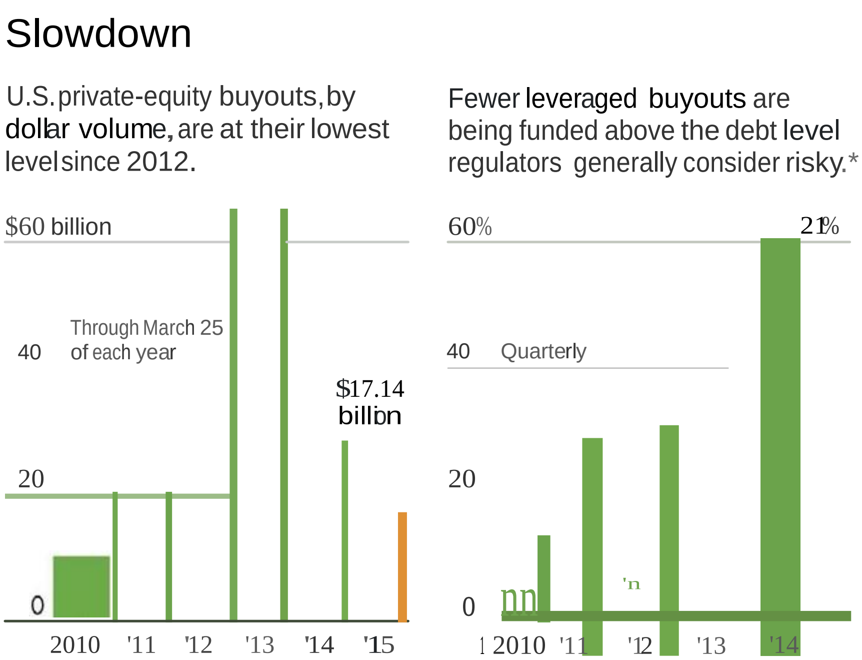
MARKETS

Buyout Firms Feel Pinch From Lending Crackdown

Regulatory guidance that seeks to limit the use of borrowed money in takeovers has hampered the business of debt-laden acquisitions



*Percentage of LBOs with leverage greater than six times Ebitda; 2015 data through March 25
Sources: Dealogic (volume); S&P CapitalIQ LCD (percentage)   THE WALL STREET JOURNAL.

By GILLIAN TAN

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An effort by regulators to deter banks from financing takeovers with high levels of debt has dealt a blow to the private-equity industry.

After resisting at first, banks have lately been falling in line with guidance regulators set in 2013, which sought to limit how much debt banks could extend for corporate takeovers. The shift is now stinging private-equity firms, whose bread-and-butter business is debt-laden buyouts.

U.S. buyouts this year have fallen. Firms spent $17.14 billion buying U.S. companies as of Wednesday, the lowest dollar volume at this point in the year since 2012 and representing the fewest deals since 2010, according to data provider Dealogic.

Loan volume, another measure of buyout activity, also has declined. About $26.5 billion in leveraged loans for U.S. private-equity buyouts and refinancings have been issued so far this year, an 82% decline over the same period in 2014 and the lowest level since 2009, according to Dealogic.

Bankers and private-equity executives said the lending pullback is creating pressure on buyout firms to do smaller deals funded with less debt and more cash. Less debt can mean less risk if the deal goes south, but also lower returns if it proves a success.

Lower profits could hurt buyout firms' investors, including pension funds and endowments that count on private-equity returns to help them meet their obligations. Buyout firms aim to at least double their investments in about five years through a sale or initial public offering.

Private-equity executives said that as their ability to use borrowed money, or leverage, has shrunk thanks to the regulatory guidance, their pool of potential buyout targets has as well.

Carlyle Group's Pete Clare says 'the limitation on leverage has taken away some buying power.' *PHOTO: BLOOMBERG NEWS*

nThe limitation on leverage has taken away some buying power and in some cases, created a gap between sellers' expectations and the price that private-equity firms can justify paying," said Pete Clare, co-head of U.S. buyouts at Carlyle Group LP.

The leveraged-lending guidance, issued in 2013 by the Federal Reserve, the Office of the

PREVIOUSLY

- Private-Equity Finns Adapt to Clampdown (htlp:llwww.wsj.com/articleslprivate-equity-finns-adapt-to-regulatory-clampdown-1417652728) (Dec.3,2014)
- Can Banks Lend for Risky Deals? Depends Wlo You Ask (http:l/online.wsj.comlarticleslregulato clarification-still-sows-banks-unease-1416438788) (Nov.19)
- Banks Sit Out Riskier Deals (http://online.wsj.comlnewslarticles/SB10001424052702304302704579334820201530010) (Jan.21, 2014)
- Lenders lve warned on Risk (http://online.wsj.comlnewslarticles/SB10001424127887324373204578374763359396602) (March 21, 2013)
- Debt Rises In Leveraged Buyouts (http:llwww.wsj.comlarticles/SB10001424052702304422704579574184101045614) (May 20,2014)

Comptroller of the Currency and the Federal Deposit Insurance Corp., followed a string of new legislation and regulatory actions after the financial crisis designed to curb excessive risk-taking and better position banks to weather a severe downturn.

The regulators urged banks to avoid putting debt of more than six times earnings before interest, taxes, depreciation and amortization, or Ebitda, on companies in most industries. They also pushed back on borrowing agreements that stretch out payment timelines or lack lender protections known as covenants.

So far this year, 21% of U.S. private-equity deals have been financed with leverage at or above levels regulators generally consider risky, according to S&P Capital IQ LCD. That is down from about 35% of deals that surpassed the risk level in the fourth quarter of 2014 and 60% in the third quarter. Some private-equity firms rely more heavily on debt financing than others.

Firms for some time have been looking to diversify away from large buyouts, partly due to competition and partly because they got burned by some troubled large deals. But private-equity executives said the lending guidance is another anchor weighing on their business model.

Carlyle and fellow private-equity firm Blackstone Group LP included language in their recently filed 2014 annual reports warning that the leverage restrictions may hurt their businesses. "To the extent that such guidance limits the amount or cost of financing we are able to obtain for our transactions, the returns on our investments may suffer," Blackstone said in a February regulatory filing. Such language wasn't in the firms' prior annual reports, though Apollo Global Management LLC and KKR & Co. flagged the guidance in both their 2013 and 2014 reports.

"The regulation makes it more difficult to put capital to work, which means the quality of deals and returns could suffer," said a senior executive at a large buyout firm.

A J.Crew store in Paris. The chain is among the private-equity-backed companies with debt levels above what regulators consider risky. *PHOTO: BLOOMBERG NEVIIS*

Meanwhile, private-equity firms are preparing for the lending pullback to complicate their ability to cash out of some older investments, as they sometimes sell to other buyout firms that fund purchases with debt.

TPG's and Leonard Green & Partners LP's J.Crew Group Inc. and Bain Capital LLC's Gymboree Corp. are among the private-equity-backed companies with debt levels well above what regulators consider risky, according to Moodys Investors Service. TPG, Leonard Green and Bain declined to comment.

Regulators have long expressed concern that high-interest-rate leveraged loans can become too burdensome if business conditions change. But banks, which sell the bulk of the loans they issue to investors, easily absorbed a spike in corporate loan defaults during the financial crisis even as other investments, such as mortgage-backed securities, nearly caused their collapse.

Some view the leveraged-lending guidance as excessive.

Private-equity firms are highly sophisticated and should be able to decide leverage levels on their own. They don't need regulatory oversight," said Todd Bowen, a partner at law firm Mayer Brown LLP who advises private-equity firms.

Fed Chairwoman Janet Yellen has acknowledged that leveraged loans probably couldn't bring down the financial system, but she has said bank supervisors should use regulatory tools to curb excessive risk-taking.

The OCC declined to comment. But Martin Pfinsgraff, the OCC's senior deputy comptroller for large-bank supervision, told The Wall Street Journal last year that the lending guidance also was aimed at private-equity firms, which he called a "significant driver of what we see as risky practices."

Executives at corporations that vie against private-equity firms in auctions said the guidance is giving them an advantage.

In a January earnings call, Roper Industries Inc. Chief Executive Brian Jellison called the restrictions on borrowing a "good new development" for the manufacturer. Thomas Joyce, the CEO of conglomerate Danaher Corp., said on an earnings call also in January that the restrictions have had a "favorable impact."

Corporate buyers are able to borrow at cheaper rates, use their pricey stock as currency, and achieve savings from overlapping costs that would elude a financial buyer. They have accounted for about $245 billion of deal activity so far this year, the highest level since the same period in 2006, according to Dealogic.

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