TRENDING TOPICS

UNCERTAIN FUTURE PROMPTS ACQUIRERS TO LENGTHEN DEBT MATURITIES

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Acquirers of middle market companies may not be facing the same financing hurdles as those targeting larger companies, but the likelihood of higher rates and a slowing economy suggests they may want to reconsider the capital structures they've pursued in recent years.

Private equity firms and corporates in pursuit of acquisitions have tacked on as much debt as lenders have allowed, taking advantage of low rates. In addition, says Nizar Tarhuni, a senior analyst at M&A data provider PitchBook Data, low rates tend to result in capital structures with shorter terms, leaving acquired companies with significant debt coming due sooner than usual.

That's problematic for private equity firms, since the slow-growth economy makes it likelier they will exit transactions at lower multiples, disappointing investors. Corporates are less concerned about exiting transactions within a certain timeframe, but heavier debt loads pose a risk for them if the economy sours, a likelihood over the next few years.

"The rate on the debt isn't necessarily what matters anymore," Tarhuni says. "[What matters is] the duration of the debt that's in the financing package."

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THE VALUE OF LONGER MATURITIES

Tarhuni adds that longer duration debt may cost a bit more, but it will be worth it because over the next several years companies are almost certain to face an economic downturn. External factors impacting companies' businesses and balance sheets can create a mismatch of assets and liabilities, if the latter come due too quickly. So the extra time provided by longer maturities can help companies through rough patches.

"If a company extends the maturity out, it's safe from having to pay off the principal during an inopportune time, and it will provide a greater chance to restructure," Tarhuni says.

He advises that private equity firms and corporates entering into new deals or seeking to refinance existing ones would be prudent to incur debt that isn't due for at least four or five years, although each borrower faces a different situation.

If the target is a quality business generating plenty of cash and showing healthy debt coverage ratios, the situation isn't as dire, Tarhuni says. On the other hand, if a significant turnaround effort is required, a longer-term solution is probably more appropriate.

REFINANCING AND FLEXIBILITY

Corporates and private equity firms may be wise to refinance debt incurred in recent years, following the same rules of thumb. "But if it can, the acquirer should be looking to swap debt instruments, extend maturities and play it safe," Tarhuni says. "The fees it pays to refinance can be thought of as a form of insurance that it hopefully will never have to use — it's managing risk in a proactive fashion."

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Acquirers should also be looking for flexibility — such as the option to buy back debt to deleverage — and as few covenants as possible. Tarhuni says bank lenders are pulling back on the "covenant lite" loans to large companies that have been prevalent in recent years. In the middle market, however, relationship lenders are still willing to forego covenants as well as amortization to continue winning business.

COMPETITION AMONG LENDERS

Another factor holding open the financing gates is that quality acquisition targets are starting to dwindle, generating more competition among lenders. A lender may now agree to a longer 8- or 10-year maturity, or eliminate covenants, so the borrower doesn't get tripped up if its business unexpectedly slows.

"As credit quality slips, the capital structure becomes that much more important," Tarhuni says.

Corporate acquirers have other considerations besides meeting certain financial multiples, including the debt already on the acquired company's books, the available interest rate, whether the overall debt can be refinanced, and whether additional debt can be tacked on to get the deal done, Tarhuni says.

LARGER COMPONENT OF SENIOR DEBT

Sponsored deals will always contain a significant portion of higher-yield mezzanine and unsecured debt to compensate lenders for the risk they're taking. However, that percentage has likely dropped on a historical basis, Tarhuni says, and traditional buyout lenders are now looking for a higher portion of senior debt.

"Mezzanine and subordinated debt will still make up the bulk of debt in these transactions, but as the quality of deals decreases, lenders will seek more seniority," he says.

To discuss these topics in more detail, please contact your PNC Relationship Manager.

Interview with Nizar Tarhuni on July 13, 2016.

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