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PRIVATE EQUITY FINANCING IN FOCUS - DIVIDEND RECAPS

PRIVATE EQUITY

Dividend recaps have been much commented on recently and have become a regular feature in our deal flow this year. We highlight some key features and issues below.

What? A dividend recapitalisation, or "recap" involves a portfolio company obtaining new financing in the loan/bond markets to fund a return to its investors. This is typically via a repayment of shareholder debt, a payment of accrued interest on shareholder debt or a special dividend. Last prominent in the 2007 market, the strong comeback for recaps offers an effective additional tool for sponsors to return value to investors.

Why? Several market features have driven the increasing volume of dividend recaps through 2012 into this year. Deal flow and exits remain supressed but at the same time markets hungry for yield, higher liquidity, increased alternative lender activity and buoyant US markets mean sponsors have found even previously conservative institutions receptive to recap deals. Sponsors can combine "taking money off the table" with obtaining more favourable financing terms for capital structures put in place during the aftermath of the financial crisis. We have advised a number of sponsors on improved terms for equity cures, future yield payments, lower margins and more extensive margin ratchets and deferred cash sweep obligations.

How? It's situation specific. Most straightforward is the upsizing of an existing facility. Alternatively a full refinancing may be preferable, most commonly via bank and/or high yield bond debt (HYB) but also via other types of financing, including the use of unitranche facilities to replace existing senior and mezzanine structures.

POINTS TO WATCH OUT FOR

As ever, the devil is in the detail:

- Looming new regulatory initiatives such as the "asset-stripping" provisions in the AIFMD (Alternative Investment Fund Managers Directive), may affect the feasibility and implementation of future recaps.
- Tax issues, including obtaining effective tax relief for finance costs and extracting proceeds to shareholders in the most tax efficient form, need to be addressed at the outset.
- Careful analysis of the documentation and investor base is needed to establish the consents required for a particular amendment or refinancing strategy.
- Investors may be supportive but find themselves constrained, e.g. CLOs reaching the end of investment periods and unable to agree extensions to their term, or investors such as debt funds may be unsupportive from the outset, and in each case strategies to neuter or minimise their impact must be explored.
- Whilst of course HYBs offer key advantages as an alternative financing source and in many ways offer considerable borrower flexibility relative to bank debt, bank debt packages offer quicker, more certain deliverability. When considering using HYBs, some of the issues our debt and capital markets teams have encountered are:
  - HYB financings are highly complex, involving different jurisdictions and sophisticated intercreditor arrangements.
  - Market standard senior/mezzanine bank debt intercreditor positions do not apply to mixed investor class scenarios, since bank and HYB investors have differing expectations around key areas such as valuation, voting and enforcement.
  - Sponsors will want to optimise covenant flexibility whilst preserving the "wins" in their current financing arrangements. This means anticipating and pre-empting negative developments (such as LIBOR floors - a product of US investor nervousness about European market conditions which effectively bump up margins), whilst exploiting sponsor-friendly market advances.
  - HYB structures can also be restrictive - for example, on the length of non-call periods and related levels of prepayment premia. Although sponsor requested portability options (i.e. a permitted one-off change of control allowing the sponsor to exit and the HYB to roll-over) are in vogue, aligning the non-call and prepayment structure with your exit strategy is frequently a better solution - and often more easily achieved in a negotiated bank debt financing, as opposed to a bond financing which will be subject to the standard market expectations of HYB investors.
  - HYBs typically require far more due diligence to support the extensive offering memorandum. Whilst new bank financings may also require considerable diligence, a refinancing carried out in conjunction with existing relationship lenders may only need a light-touch updating of prior due diligence.

CONTACT DETAILS

If you would like to discuss dividend recaps in more detail, please contact:

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