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Deal Contingent Foreign Currency Hedging in Cross-Border Transactions

By Raymond Y. Lin and Vladimir Maly

With the proliferation of cross-border private equity transactions, foreign currency ("FX") risk has become increasingly important to private equity firms and financial sponsors.

There are generally two areas of FX risk in typical leveraged transactions:

- Purchase Risk and
- Operational Risk.

Purchase Risk

FX risk exposure is created when there is a difference in the currency used to finance an acquisition and the currency of the purchase consideration of the acquisition. A typical example is when a US based private equity fund has commitments in US dollars from its private equity fund investors, but the target is being acquired in euros. In addition, in larger deals it may also be necessary to tap the US dollar denominated debt capital markets for efficient execution. Another possibility is that in order to hedge the operational risk, a private equity firm may prefer using US dollar denominated debt even though the purchase price is in euros.

Operational Risk

Operational FX risk exists when the revenues of the acquisition target involve (1) multiple currencies, (2) currencies that are different from the currencies in which the acquisition target reports or (3) a currency or currencies that are different from the currency in which the private equity firm reports. Generally, a natural hedge for revenue risks is to have expenses in matching currencies. The typical natural hedge would be to put the debt leverage in a currency that would help to mitigate FX exposure.

Mitigating Purchase Risk

To mitigate the purchase risk, the acquiring company can enter into various hedging contracts prior to the acquisition. There are essentially two types of over-the-counter currency hedging transactions widely available in the market:

- Forward Purchase Transactions and
- Option Transactions.

Forward Purchase Transactions

FX spot trade markets operate generally on a T+2 settlement basis. Forward Purchase Transactions are, in essence, foreign exchange trades with delayed settlement. A plain vanilla forward purchase transaction is a bilateral contract pursuant to which the forward purchaser agrees to purchase from the forward seller a predetermined amount in one currency for a specified amount in another currency at certain date in the future. The 'forward rate,' the rate at which the future exchange of different

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currencies is calculated, is typically above or below the relevant spot rate at the time the parties enter into the forward purchase transaction. The difference between the spot rate and the forward rate is the forward premium or forward discount. Such forward premium/ discount is determined based on the anticipated movements in the FX market prior to the maturity of the forward purchase transaction. No payment is due by either party under a forward purchase contract until the settlement date.

The difficulty of achieving an efficient hedge of the purchase risk results from the fact that at the time the hedging contracts are entered into, the private equity and financial sponsors are not yet certain as to whether the acquisition will be successful.

Entering into forward purchase transactions allows the sponsors to hedge the risk of any downside movement of the FX markets. On the other hand, it doesn't give them the opportunity to benefit from any favorable movements in rates between the trade date of the forward contract and its maturity date.

Option Transactions

Currency option transactions allow the sponsors to hedge any adverse movements in foreign exchange rates while not preventing them from benefiting from any future upside. An option is a bilateral contract between the 'option buyer' and the 'option seller' pursuant to which the option buyer is granted the right to purchase a specified amount in a specified currency at a pre-agreed exchange rate. The exchange rate used to calculate the amount payable by the option buyer upon exercise of the option is referred to as the 'strike price.' For this right the option buyer has to pay a premium which is payable at its maturity regardless of whether or not the option is exercised. The amount of the premium payable is determined on the trade date. It will depend, in part, on the volatility of the two currencies and the period that the option is designed to cover.

There are several types of plain vanilla currency options widely available in the over-the-counter markets. Depending on the dates on which the option may be exercised, we can distinguish between European, Bermudan and American-style options. A European option may be exercised only at the expiry date. An American option may be exercised at any time prior to the expiry date, while a Bermudan option allows the buyer of the option to exercise the option on any of several pre-defined specified dates. While American and Bermudan-style FX options would give the sponsors the flexibility to exercise the option and thus purchase the currency as and when required, most of the over-the-counter currency options used on large acquisition transactions are European-style as the flexibility provided by American or Bermudan-style options typically increases the amount of premium payable by the buyer. Although the European-style option does not give the option buyer a contractual right to exercise the option prior to its maturity, the buyer of the European-style option effectively has the right to match maturities by selling the option back to the option seller or to a third party at any time prior to its exercise date. At that point, if the option is in the money, the holder upon sale of the option should be able to realize the "in the money value," as well as the remaining time value of the option. Even if the option is "out of the money" at that point, the option will still have time value since currency rates may move before its maturity date.

Deal Contingent Hedging Contracts

The difficulty of achieving an efficient hedge of the purchase risk results from the fact that at the time the hedging contracts are entered into, the private equity and financial sponsors are not yet certain as to whether the acquisition will be successful. It may turn out, for example, that it will not be possible to carry out the acquisition due to regulatory reasons or because the transaction is dependent upon a shareholder vote. To the extent that the acquisition does take place, it is still unlikely to be clear at the date the definitive acquisition agreements are entered into (which is likely to be the trade date of any related hedging contracts) what will be the exact closing date of the acquisition and what will be the date or dates on which the foreign currency will be required. There are therefore two factors that need to be taken into account when hedges are put in place with respect to a private equity acquisition transaction:

- Upfront costs incurred in case the acquisition does not take place and
- Flexibility of multiple settlement/exercise or extension of the hedging contracts.

Plain vanilla forward purchase contracts require the forward purchaser to purchase the foreign currency on the future date. Plain vanilla option contracts do not require the option buyer to purchase the foreign currency, but do require the buyer to pay a

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Private Equity Deal Highlights

Our comprehensive experience in all aspects of private equity investment enables us to service the full array of legal needs of fund sponsors and investors alike, from fund formation to investment acquisition, structuring, financing and disposition. The following is a selection of US deals.

AMC Entertainment Inc.
Apollo Management LP
JPMorgan Partners

Acquisition by AMC Entertainment Inc. of Loews Cineplex Entertainment Corporation

2006

Not Public

Apollo Management LP

Acquisition by Apollo Management LP of International Paper Co.'s coated-paper business to CMP Holdings LLC

Pending

$1,400,000,000

Dex Media, Inc.
The Carlyle Group
Welsh, Carson, Anderson & Stowe

Acquisition of Dex Media, Inc. by R.H. Donnelley Corporation

2006

$9,800,000,000

Kelso & Company

Acquisition by Kelso & Company of all ownership interests of Hallmark Entertainment, LLC from Hallmark Cards

2006

Not Public

Kohlberg Kravis Roberts & Co.

Acquisition by Kohlberg Kravis Roberts & Co. (KKR), Bain Capital and Vornado Realty Trust of Toys "R" Us

2005

$6,600,000,000

Kohlberg Kravis Roberts & Co./Silver Lake Partners

Acquisition by Kohlberg Kravis Roberts & Co. (KKR) and Silver Lake Partners of Agilent Technologies, Inc.'s Semi-conductor Products Group (SPG)

2006

$2,660,000,000

LS Power Equity Partners

Acquisition by LS Power of Duke Energy's DENA Power Generation Assets

2006

$1,600,000,000

Odyssey Investment Partners LLC

Acquisition by Odyssey Investment Partners LLC of York Insurance Services Group

2006

$105,000,000

Silver Lake Partners

Acquisition by Silver Lake Partners of Serena Software, Inc.

2006

$1,200,000,000

The Carlyle Group

Sale by The Carlyle Group of Rexnord Corporation to Apollo Management LP

Pending

$1,830,000,000

The Goldman Sachs Group Inc.

Sale by The Goldman Sachs Group Inc. of East Coast Power, LLC, to General Electric Capital Corporation

2006

Not Public

The Yucaipa Companies LLC

Representation of The Yucaipa Companies LLC as plan sponsor in connection with the acquisition of Aloha Airlines through a plan of reorganization

2006

Not Public

VNU Acquisition Consortium

Acquisition by a consortium of six private equity firms including AlpInvest Partners N.A., The Blackstone Group L.P., The Carlyle Group, Hellman & Friedman LLC, Kohlberg Kravis Roberts & Co. and Thomas H. Lee Partners, L.P. of VNU NV

2006

$11,300,000,000

Welsh Carson Anderson & Stowe

Acquisition by Welsh Carson Anderson & Stowe of a majority interest in Axesa Servicios de Informacion (formerly known as Verizon Information Services - Puerto Rico) from Verizon Information Services, Inc.

2006

Not Public

Deal Talk with Jörg Kirchner

By David S. Allinson

This issue's *Deal Talk* interview features Jörg Kirchner. Jörg Kirchner is the Office Managing Partner of Latham's Munich office. He represents clients in private equity and M&A matters, handling primarily cross-border and national transactions.

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Question: Jörg, as a private equity practitioner who specializes in cross-border transactions, what current developments in cross-border private equity transactions do you believe are the most significant or noteworthy?

Answer: The last few years have seen a substantial rise in the share of private equity transactions in the European cross-border M&A market. The drivers behind this development were large LBOs with enterprise values in excess of €1 billion. At the same time the market for this segment has become more competitive than ever before. US and European buy-out funds have raised funds with record highs, interest rates are at a historically low level and debt leverage ratios are at a historic high. In addition, the corporate strategic buyers are back with substantial purchasing power, competing with private equity investors for large acquisitions.

Question: Are you seeing a significant number of consortium ("club") deals in Europe? Is there a trend, like there is in the US, where bigger companies are being taken private with many more club members?

Answer: Like the US, we are seeing more club deals in Europe. Two examples are the recent $12 billion takeover of the Danish telecoms company TDC by a private equity consortium and the pending €7.58 billion bid for the Dutch media conglomerate VNU. The club deals are getting bigger in size and, as evidenced by VNU, bigger deals often require more club members to raise equity. I also believe it is inevitable that we will see more public companies going private because the larger private equity firms, flush with more cash, have to broaden their field of acquisition opportunities.

Question: Have the financing structures for European leveraged buy-outs become more complex in the last couple of years? How many layers of debt are typical for a European private equity deal? What is being utilized more – second lien secured debt or unsecured high yield senior subordinated debt?

Answer: Financing structures have certainly become more complex due to the increasing number of large cross-border transactions which require sophisticated structures to accommodate national financial assistance requirements, as well as thin capitalization or other tax rules. At the same time, capital structures have become more sophisticated to allow the involvement of interested hedge funds or other market players that want to play a role in the financing of the targets.

An acquisition financing in Europe is often financed in three layers, which consist of senior debt and subordinated debt on the operating company ("opco") level and high yield bonds, which are normally issued by the holding company. Subordinated debt would either consist of second lien debt or mezzanine and would be subordinated as to repayment and enforcement. High yield bonds are typically secured by upstream guarantees of opco.

Question: Do you believe that we will continue to see an increase in cross-border transactions between European jurisdictions, as well as between Europe and North America? If so, why?

"US and European buy-out funds have raised funds with record highs, interest rates are at a historically low level and debt leverage ratios are at a historic high."

Answer: I am absolutely convinced that cross-border transactions will continue to increase. Every medium-sized and large LBO has become the source for a cross-border transaction. This is due to the increasing globalization of the supplier and customer relationships of the targets, as well as the European-wide investment focus of the private equity funds, whether US or UK, French, Scandinavian or other European funds.

Question: For the last couple of years, I have heard and read many stories saying that the business climate in certain European countries, such as Germany's, is somewhat opposed to private equity sponsors acquiring companies. Given the significant number of private equity transactions announced in the last six months across Europe, including Germany, would you say the business climate is changing and that financial sponsor deals are now just accepted?

Answer: It is true that Germany, in particular, has recently seen fierce debates about the role that private equity investors play or should play in the German market. This was mainly triggered by the somewhat populist remarks made by a member of the former government comparing private equity investors with "locusts" who squeeze out profits from their unlucky target companies with no consideration for their future. Ironically the new government, which is partially made up of members from the former government, recently sold roughly five percent of the shares in Deutsche Telekom AG to Blackstone. This and the media attention following the "locusts" debate should have served to further prepare the grounds for the social acceptance of private equity investors, in particular among the owners of mid-sized companies (so-called Mittelstand), a market which has proven to be a difficult one for non-German funds.

Question: You mentioned the recent investment of Blackstone in Deutsche Telekom AG, which received a lot of attention in the US press. Do you think acquiring minority interests in public companies will become a trend for private equity deals or do you think the Blackstone transaction just signals greater interest in European listed companies?

Answer: It is doubtful that a large number of funds will follow this example and make minority investments in listed companies. While in Germany public takeovers by private equity investors have been relatively rare due to the strong presence of large buy-out funds in the market and the increasing pressure to find suitable targets, the likelihood of a consortium investing in a major public company in Germany has certainly increased. Only 10 of the 30 companies listed in the German Dax have a market capitalization of more than €25 billion. ■

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Outsourcing In Carve-Out Transactions

By Robert E. L. Hasty and Jeffrey A. Tochner

Outsourcing is becoming a more prevalent feature of private equity acquisitions, particularly in "carve-out" transactions, where the target is an integrated part of the seller's business and uses back office systems and services that are shared among the seller's other operations. Examples include IT hardware and software systems, data processing centers, help desks, networks and applications development and maintenance, as well as other back office functions such as finance and accounting, human resources, procurement and logistics.

These back office support systems and services may either be provided directly by the seller using its own resources, facilities and equipment, or, as is becoming more common, they may be outsourced by the seller to a third party vendor.

Strategic buyers usually have systems and services in place to support their preexisting business operations and can simply migrate the target to them. Financial buyers, on the other hand, typically do not have infrastructure in place to do so. Accordingly, in private equity acquisitions, these systems and services often continue to be provided by the seller (by itself or through its outsource vendors) on a transitional basis for a period after closing. Following the transition period, the portfolio company must either 'in-source' these systems and services by investing in the infrastructure and resources necessary to support itself, or, as is becoming more prevalent, the portfolio company may choose to outsource them, in whole or in part.

This article identifies and discusses certain key issues that private equity sponsors and portfolio company management should consider when faced with the prospect of replacing the seller's shared systems and services in carve-out transactions.

Due Diligence

In order to create the back office systems and services necessary to support the business of the portfolio company, it is desirable to gain as much insight as possible into the seller's systems and services that are to be replaced. This information is equally important whether these systems and services are in-sourced or outsourced. By understanding the current environment for these systems and services, the private equity sponsors, portfolio company management or its outsource vendor, will be in a better position to duplicate that environment or design a new one, as well as plan and manage the inevitable transition off of the seller's current environment, whether the transition takes place upon closing or at the end of a transition services period.

Similarly, it is advisable to obtain as much detail as possible on how much it currently costs the seller to provide these systems and services to the target and how much the seller will charge to continue providing them as transition services following closing. This information not only is important for budgeting purposes, but it also provides a good benchmark for negotiating with an outsourcing vendor, both to validate that the vendor has correctly scoped the systems and services to be provided, as well as to validate the price the vendor is quoting.

The due diligence on the seller's current environment should include not only quantitative and technical information, such as inventories of various resources and technological designs or configurations, but also qualitative aspects of the current systems and services. Quality is a key element of scope, and is a key driver of the cost of any replacement solution, whether in-sourced or outsourced. This includes metrics on the recent historical performance of the systems and services, especially in the form of service levels, if available, as well as less empirical aspects of quality. While the qualitative information may be more difficult to obtain or ascertain, it is critical to ensuring continuity of "business as usual" operations for the target and the soundness of budgetary projections.

Third-party dependencies (such as software used to provide the services) are also of critical importance and should be identified as early as possible during due diligence. Consents or new licenses may be required, both during and following the transition period, and these may be time consuming and expensive to obtain.

Because it takes significant time and effort to collect and provide this information, sellers often resist such efforts, particularly in heady auctions where the buyer's leverage is often limited. Nonetheless, it is advisable to press for such information, as appropriate, in the context of the overall negotiations, because this information will facilitate the transition and avoid potentially costly problems, such as disruptions to the target's business.

Deciding What to Outsource

Because it can be extremely expensive and require a great deal of initial and ongoing management attention to create infrastructure to replicate all of the systems and services that the seller provided to the target prior to closing, it has become more common for financial buyers to outsource many of these systems and services. There are a number of considerations in deciding whether to outsource, and if so, what to outsource.

One of the earliest drivers for outsourcing, and a guiding principle in what functions may be candidates for outsourcing, is the concept that any non-core functions should be considered to be handed over to experts in those respective areas in order to free management to focus its attention on core functions. What is 'core' versus 'non-core,' however, is not a bright line and has evolved over time. Functions that may intuitively be viewed as core functions for a particular type of enterprise may quite commonly be outsourced. For example, banks outsource their deposits and payments processing, trust services, account management systems and statement production. Insurance companies outsource their call centers, applications processing, claims processing and adjustors. Managed care companies may employ few or no doctors that see patients. Investment banks outsource market research, and private equity firms outsource fund administration.

In the end, the specific circumstances of each target (and its investors) are paramount. For example, because cash management may be extremely important to financial buyers, particularly if the target is a distressed business, it may be desirable to handle treasury functions internally. In certain circumstances, however, it may be more cost effective, or it may better enable the target to meet its financial objectives, if other functions are outsourced, such as IT, HR and payroll. Outsourcing such other functions may reduce capital expenditure requirements in the near term, which would allow available capital to be focused more on expanding the business into new markets, rolling out new products and services or rolling them out sooner, which may produce higher returns on capital than investments in back office systems or functions.

Timing Considerations

In a typical carve-out transaction, where a substantial portion of the back office functions are provided by the seller to the target prior to closing, financial buyers will often need at least one year (and sometimes 18 months or more) to acquire or otherwise assemble all the necessary resources and systems to perform the services in-house. Outsourcing these systems may reduce the amount of time needed to become independent of the seller's systems because an outsourcing vendor may be able to leverage its existing systems or service functions for the target. Still, a significant amount of time may be required because there may be customizations to be identified, designed and implemented in order for the vendor's standard systems or service offerings to meet the target's needs. There usually will be interfaces that must be created between the vendor's environment and the target's other systems or services, and a transition must always be planned and executed.

Pursuing outsourcing will also necessarily entail an investment of time to negotiate an agreement with the vendor that defines the scope of the systems and services to be provided (including service levels and other qualitative aspects of scope), the parties' respective obligations and allocations of risk, as well as the economic terms. Whether the decision is to in-source or outsource, appropriate care – and therefore time – must be taken to either stand up and transition to internal systems or services, or to negotiate a robust, comprehensive outsourcing agreement and transition to an outsourced environment. In either case, underestimating or under-investing in the effort can lead to cost overruns and disruptions in business operations.

Accordingly, the process should begin as soon as possible, ideally prior to or immediately following the signing of the merger or acquisition agreement. Some discrete services and functions, such as payroll, may take 30 days or less to stand up or outsource. Others, such as complex information technology systems, may take a year or more. Where there is a substantial amount of time between signing and closing, there may be time to be able to have certain systems or services in place at closing, thereby avoiding the cost of and dependence upon transition services provided by the seller post-closing.

Whenever transition to the target's systems or services is to take place, and whether they are in-sourced or outsourced, it is of critical importance to allow sufficient time to stand up the necessary systems or services, test them appropriately, migrate and load historical data and transfer know-how. Given the complexity of these tasks, they may take more time than expected; accordingly, the contractual arrangements with the seller should give the buyer flexibility to obtain or extend transition services if the transition from the seller's environment takes longer than expected.

Outsourcing is a useful tool for private equity sponsors to manage more effectively and economically the transition to independence of targets in carve-out transactions. In order to determine whether outsourcing makes sense in a particular deal and to maximize the benefits of outsourcing, however, careful due diligence and planning is required. With proper due diligence and planning, and with the use of outsourcing in appropriate circumstances, private equity sponsors can minimize the possibility of transitional disruptions to the business of the portfolio company following the closing, and can focus management's attention on improving the core business, potentially increasing returns on investment in the acquisition. ■

Latham & Watkins has a leading Outsourcing practice. For more information on this article and related issues, please contact **Jeffrey Tochner** in our New York office at +1-212-906-1200 or **Robert Hasty** in our Washington, D.C. office at +1-202-637-2200.

Industry specialists in a number of fields will be providing articles in upcoming issues of *SmartCapital — US Edition*. For a list of other areas of Latham's industry expertise, please refer to Page 12.

premium. In both cases, private equity companies and sponsors would end up incurring hedging costs regardless of whether or not the acquisition is successful. Generally, private equity sponsors do not like to pay financing fees (such as debt commitment fees) unless a transaction closes since they generally do not have access to their investment fund for non-completed transactions. Most banks have accepted the proposition that debt commitment fees are contingent upon the closing of a transaction. With respect to hedging transactions, however, until recently, banks have required the payment of option premium fees or that a forward contract close regardless of whether the underlying acquisition transaction closes.

Some banks have started offering new products, commonly known as 'deal contingent hedging contracts' to address the risk that the acquisition may not ultimately take place. Deal contingent options and deal contingent forwards are contracts pursuant to which payments by both parties are contingent on an event that is linked to the acquisition transaction.

> **. . . as long as such contracts are structured as deal contingent, no increase in price due to enhanced flexibility will affect the private equity investors and sponsors if the acquisition of the target does not take place.**

The exact nature of the 'contingency' depends on the acquisition method and is negotiated on a deal-by-deal basis (for example, such trigger event can be a declaration of a tender offer to be unconditional or an acquisition of a certain minimum percentage of shares of the target company).

To the extent that the trigger event does not occur prior to the maturity of the hedging contract, no payments will be due by either party. Costs for the contingency aspect of such hedging contracts are typically reflected in the forward premium/discount or option premium, as applicable. Such costs, however, are only payable upon the settlement of the hedging contracts and are therefore contingent on the occurrence of the trigger event. The banks typically prevent a private equity sponsor from "gaming" the system (by delaying a closing to a date beyond the hedge expiration date) to avoid paying the hedging fees by inserting a "moral obligation clause" or tail provisions that provide that if a deal contingency does not come to pass before the expiration of the hedge, but does occur within a short period afterwards, the payments with respect to such hedge contract have to be made by both parties at such later date.

In addition, multiple partial exercise features may be built into forward purchase and option contracts to give the sponsors the requisite flexibility to draw on the currency hedges each time a partial payment with respect to the acquisition becomes due. The level of flexibility built into the hedging contracts in terms of allowing for exercise or settlement on multiple days, ability to exercise or settle only a portion of the notional amount of the contract or giving the option buyer/forward purchaser a unilateral right to extend the maturity of the contract results in an increased price for such hedging contracts. As long as such contracts are structured as deal contingent, however, no increase in price due to enhanced flexibility will affect the private equity investors and sponsors if the acquisition of the target does not take place.

Conclusion

Private equity investors who are financing acquisitions in currencies other than the purchase price for the target are exposed to foreign exchange fluctuations. In a volatile FX environment, it may be necessary to hedge such foreign exchange risk through a series of hedging contracts. Building deal contingency features into vanilla option and forward contracts is an innovative way of reducing the FX risks without incurring any costs in case the acquisition does not materialize.

From the point of view of the banks, deal contingent hedges are difficult products to price and present significant risks. In the plain vanilla forward or option hedge contract, a bank will typically enter into an off-setting transaction to mitigate some or all of the risks that it assumes pursuant to such forward or option hedge contract. It would be difficult to find a "matching" hedge with respect to the deal contingency risk and, therefore, these products may not be widely available. Despite the difficulties in pricing and mitigating risk on the part of the banks, we are likely to see more deal contingent hedging structures in the future as more and more dealers of over-the-counter currency options are now able to offer such products. ■

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Are Hybrid Bonds the Next Big Thing in Leveraged Finance?

By Bryant Edwards & Rudolf Haas

Hybrid securities, developed by banks and financial institutions to bolster their regulatory capital, have in the last two years become increasingly popular with seasoned European corporate issuers.

Hybrid bonds offer many of the benefits of issuing equity at less cost than actual equity with no dilutive effect on outstanding share capital. IFRS allows European companies to treat certain hybrid bonds as equity on their balance sheets, strengthening their leverage ratios. The rating agencies give hybrid bonds whole or partial equity credit, boosting the issuers' credit ratings. Yet most companies are able to treat hybrid bonds as debt for tax purposes, allowing them to deduct interest payments.

To date, most hybrid bonds have been issued by investment-grade European companies, such as the $1 billion Porsche offering in January 2006 and the €1.3 billion Bayer AG offering in July 2005.

Because the interest payments on hybrid bonds can be deferred, in some cases indefinitely, and holders' remedies in a distressed situation are extremely limited, in the past, hybrid bonds have been considered most appropriate for investment-grade corporate issuers with limited risk of default.

Recently, non-investment grade issuers have successfully tapped the hybrid market. Casino Guichard, a French retailing group, issued €600 million of BB+-rated hybrid bonds in January 2005, an issue pegged two notches below Casino's senior rating. TUI, a large German tourism and shipping company, issued €300 million of B+-rated hybrid bonds in December 2005. Both offerings were highly oversubscribed.

Using Hybrid Bonds in Leveraged Acquisitions

TUI used the proceeds of its offering to help finance its €1.7 billion acquisition of CP Ships, a Canadian shipping company. Most recently, Lottomatica announced its plan to finance its €4 billion acquisition of Gtech, among other things, with a €750 million hybrid bond. This issuance will be the first use of hybrid bonds in a structured European leveraged acquisition.

Are Hybrid Bonds a Real Financing Option for Non-Investment Grade Issuers Making Leveraged Acquisitions?

In recent years, the financing structures for European leveraged acquisitions have become more complex, with additional layers of debt utilized to appeal to new investor groups (such as hedge funds) and to increase leverage. Where in the past European leveraged buyouts frequently consisted of two layers — senior bank debt and European mezzanine debt — acquisition debt today often uses three or four layers, including first and second lien senior secured debt, unsecured high yield senior subordinated debt or structurally subordinated holding company pay-in-kind (PIK) bonds or loans. In acquisition finance, hybrid bonds would be the most junior level of acquisition debt and would likely replace the PIK debt in European leveraged acquisitions.

For sponsors and other leveraged buyers, hybrid bonds have significant advantages over holding company PIK debt as acquisition financing. Because they receive whole or partial equity treatment by the rating agencies, hybrid bonds may serve as a partial substitute for the equity that sponsors would otherwise be required to put in such an acquisition. Unlike holding company PIK bonds, which in general restrict any payment of dividends to the sponsors, hybrid bonds have no negative covenants or restrictions on the payment of dividends, allowing the sponsors to receive dividends and other restricted payments permitted by the other debt instruments. Moreover, because of the "soft" payment features of hybrid bonds, the lack of covenants and the inability of holders to declare a default other than in a liquidation, hybrid bonds would be "patient" capital, providing more time for the shareholders to complete a workout that preserves value for all investors, particularly the equity.

Unlike holding company PIK bonds. . . hybrid bonds have no negative covenants or restrictions on the payment of dividends, allowing the sponsors to receive dividends and other restricted payments permitted by the other debt instruments.

In contrast, holding company PIK bonds, covenants, cross-payment defaults and cross-acceleration rights give their holders more leverage to "get to the table" in a restructuring and more ability to put pressure on the equity.

Will Institutional Investors Buy Non-Investment Grade Hybrids?

Yield-hungry investors have been lured by the high interest rates paid on hybrid bonds issued by non-investment grade issuers. For instance, the TUI hybrid bonds paid an initial fixed rate of 8.625 percent — 350 basis points over the 5.125 percent interest rate offered on the TUI senior notes that were sold in a simultaneous offering. But 350 basis points is low compared to the 450 to 600 basis point premium (over the next layer of debt) that sponsors had to pay hedge funds and other institutional investors for buying holding company PIK notes in recent leveraged European acquisitions.

That pricing disparity raises the question of whether hybrid bond investors are adequately compensated for the additional risk of holding a security with such limited remedies. Many institutional investors have stayed clear of this market and urged caution, worried about the limited rights that hybrid bonds provide investors.

Institutional investors have focused on the following features of hybrid bonds:

No Maturity Date. Most hybrid bonds are perpetual bonds. Most convert to floating rate pricing with an interest rate step-up of up to 100 basis points after eight or 10 years, which with a right at such time to redeem the hybrid bonds with the proceeds of an equity or pari passu offering, encourages the issuer to refinance the hybrid bonds.

Deferral of Interest Payments. Most hybrid bonds permit deferral of interest payments for up to 10 years, or even indefinitely in some cases, so long as the issuer does not redeem, repurchase or pay dividends to any security that is pari passu or junior to the hybrid bonds, including its share capital. Unlike typical preferred share capital, hybrid bondholders get no board representation or any other remedy upon such a deferral. Interest does not accrue on such deferred payments, so there is an economic benefit to the issuer in deferring such payments.

No Covenants and Limited Events of Default. Hybrid bonds have no covenants, so holders have no remedies for corporate actions that would constitute events of default under traditional corporate debt instruments. In addition, hybrid bonds have no payment defaults, no cross-defaults or cross-acceleration defaults. The only event in which hybrid bondholders can declare the bonds due and payable is a liquidation or dissolution of the issuer.

Deep Subordination. The principal of hybrid bonds is typically fully subordinated to all other debt of the issuer. Generally, deferred interest on hybrid bonds would be treated as equity interest, not a debt claim in an insolvency. Hybrid bondholders would only recover deferred interest to the extent that shareholders receive value in an insolvency.

This limited package of rights and remedies will certainly raise red flags for institutional investors, particularly for those hybrid bonds used as a junior level of debt capital for leveraged acquisitions.

Since most European restructurings are accomplished through out-of-court settlements or schemes of arrangements, lenders and investors must have the rights and remedies that will get them "to the table" in workout negotiations. In some aspects, however, hybrid bondholders will be less able to do so than shareholders. In an out-of-court restructuring in which debt is being exchanged for equity, for instance, the issuer will likely need approval from the shareholders for a share capital increase, giving the shareholders leverage in negotiating a recovery. Since hybrid bondholders can only declare the bonds due and payable upon a liquidation or dissolution, which is unlikely in such a restructuring, they have few cards to play in a negotiated restructuring.

Conclusion

While we believe that hybrid bonds offer significant benefits for European corporate issuers and for sponsors in leveraged acquisitions, we predict that institutional investors for non-investment grade paper will continue to be troubled by the lack of rights and remedies inherent in hybrid bonds and that there will not be significant buyers unless hybrid bonds are priced to take such limitations appropriately into account. ■

Industry Focus

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