Article Title: ARCHIVE | Criteria | Corporates | General: LBO Equity Hybrids: Too Good To Be True Data: (EDITOR'S NOTE: —This criteria was orginally published On Aug. 10, 2007. We are republishing the article following our periodic review completed on July 28, 2010. It has been superseded by the article titled "Hybrid Capital Handbook: Septemeber 2008 Edition," published Sept. 15, 2008.) For the past few years, leveraged acquisition activity has employed ever-greater financial leverage. To stretch still more, equity hybrids have been introduced for such buyouts. A recently popular hybrid security for this purpose provides LBOs with a modicum of equity--or, at least the appearance of equity. The security is a preferred stock held by owners of common stock, and has the following terms: Perpetual; High dividend yield; Option of payment-in-kind (PIK), at the discretion of the company, for life of security; Some versions provide for PIK only, with no cash payments of dividends for life of security; Deeply subordinated; and Needs to be redeemed only upon change of control. At first blush, the security is extremely equity-like. However, Standard & Poor's Ratings Services is skeptical about the benefit of this security for the company's long-term credit quality. We do not assign it any equity credit--and treat it as debt in calculating credit ratios. We specifically are concerned about the incentives created by this structure to pay the dividend in cash where possible--even though not required to--and/or orchestrate a change of control. The LBO context--i.e., very aggressive financial policies of owner/sponsors--heightens our concerns. In the case of aggressive LBO owners, common equity itself is ephemeral: Indeed, for most LBOs, the overarching rating consideration is the risk associated with future owner actions, rather than the specifics of the current balance sheet. (Please see Credit FAQ: Knowing The Investors In A Company’s Debt And Equity, published April 4, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.) Roadmap For Payments The current genre of equity sponsors, to generalize, has a track record of taking out their investment in owned entities very quickly--via cash dividends and fees of all types. We should not expect these controlling shareholders to defer cash payment of dividends on preferred securities they hold. Rather, the preferred should be seen as a vehicle--apart from other ways to extract cash--for owners to cash out. The yield on these securities is usually quite robust. Thus, the preferred is a roadmap for one avenue owners can use to take out significant amounts of cash. If there is no cash payment option, there will be no cash payments, of course. But the owners will still want to see a return on the investment represented by the preferred stake--especially as the value of the preferred investment will accrete quite rapidly, given the high dividend rate. The change-of-control redemption provision can provide the mechanism for doing just that. Change-Of-Control Redemption Even though the common share owners can cash out in various ways, there is an incentive--often a growing incentive--to realize the value of their preferred stake. Indeed, their investment will shift to the preferred stock--as taking out common dividends reduces the common equity, while paying the preferred dividends in kind leads to an ever-larger preferred investment. Ultimately, the preferred value may exceed the common value many times over. This sets the stage for re-capitalizing. The owners can orchestrate a change of control to trigger payment of the preferred. The change can be bona fide or contrived. Either way, the preferred likely will be replaced with debt. Because the entity will be saddled with the takeout debt upon the expected change-of-control, we view this security as eventual debt, rather than equity, and include that debt immediately in metrics such as debt/cash flow. In other instances where there are incentives to replace hybrid equity securities, we similarly are concerned that they will be replaced with debt, and we grant no equity credit. For example, in the case of hybrids with a step-up, we presume they will be called and replaced with debt in the absence of any specific replacement commitment. Note that we ordinarily treat potential change-of-control as event risk. Change of control instigated not from within the company, but from without, is unpredictable and deemed to be beyond the pale of ratings analysis. However, regarding the security addressed here, change-of-control is foretold by the terms of the security and the structure of the capital base.