Opinion

Chris Bryant, Columnist

Where Are All the Private Equity Bankruptcies?

Defaults are rising but sponsors have the money, tools and motivation to avert disaster.

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By Chris Bryant
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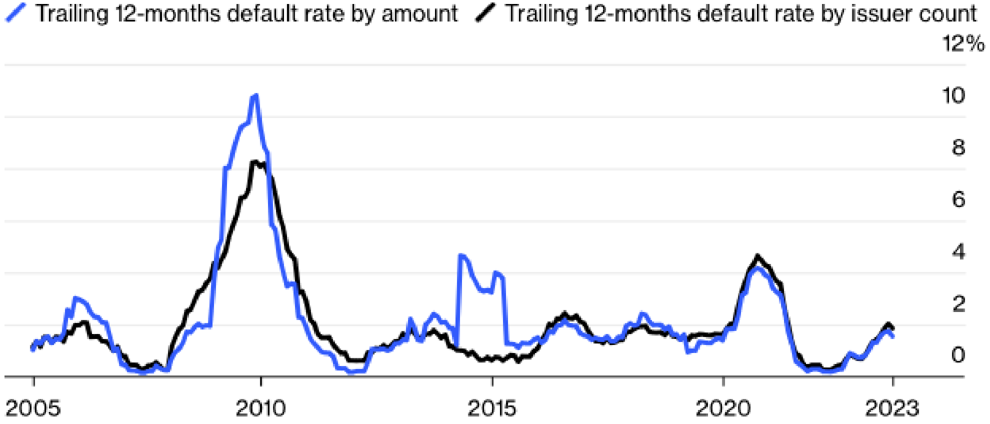
Few companies have felt the shock from soaring interest rates as much as those owned by private equity. But thanks to surprisingly resilient earnings and their deep-pocketed owners' talent for financial engineering most are avoiding disaster.

There have been some big bankruptcies, including the collapse of Envision Healthcare Corp. in May just five years after it was acquired by KKR & Co. for $9.4 billion. But so far, default rates have been lower than during the global financial crisis and the early part of the pandemic. While PE investors face lower returns, the financial reckoning may be less acute than I initially expected – providing there isn't a deep recession.

US Leveraged Loan Defaults Have Risen

But they're still well below levels reached during the pandemic and global financial crisis



Source: Pitchbook LCD
Note: defaults refer to the Morningstar LSTA US Leveraged Loan Index. Includes missed interest

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Note: defaults refer to the Morningstar LSTA US Leveraged Loan Index. Includes missed interest payments, bankruptcy filings or when S&P downgrades the loan to "D". Does not include distressed exchanges.

Following a decade in which cheap money fueled a buyout boom featuring increasingly optimistic valuations, the most aggressive rate-hiking cycle in decades has triggered a hangover.

With takeovers and IPOs subdued, PE firms can't play pass the parcel with assets anymore, and the interest expenses on their portfolio companies' floating-rate borrowings have often more than doubled.

Given the supposed financial sophistication of this industry, it's surprising how few PE firms hedged this interest-rate exposure. Around two-thirds of the $1.4 trillion US leveraged loans market was unprotected at the end of the 2021, after which hedging became much more expensive, according to Oaktree Capital Management.

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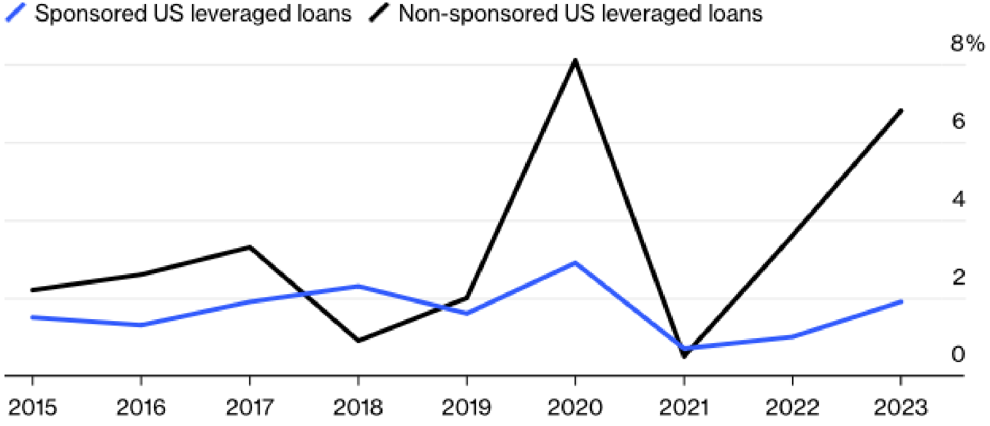
US institutional leveraged-loan defaults trebled to 3% in July compared with mid-2022, according to Fitch Ratings, which uses a trailing 12-month basis and includes so-called distressed exchanges (I'll say more about those in a bit). However, in value terms, the default rate on PE-backed loans was lower than those without sponsor support.

Private Equity Shield

Defaults by PE-backed firms are hurting less than those without sponsor backing



Source: Fitch Ratings US Leveraged Loan Default Index
Note: Data is on a trailing 12-month basis by value. 2023 is as of June 2023. Sponsored refers to loans to borrowers that have a PE owner. Non-sponsored loans primarily relate to publicly traded entities. Defaults include distressed exchanges

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Overall, Fitch expects default rates on US and European leveraged loans to climb to as much as 4.5% this year and remain close to that level in 2024. This wouldn't be a disaster for LBO debt investors as syndicated leveraged loans currently yield more than 9% and private credit yields are nearer 12%.

Are Yields Attractive Enough?

US leveraged loan investors are betting defaults won't be a big problem

Source: Bloomberg, Morningstar

Against rising interest costs, corporate earnings have been better than expected. “These companies are still growing [earnings], and they're doing it now, having absorbed higher rates and dealt with all the inflationary pressures on the cost side of their business,” Michael Arougheti, co-founder and chief executive officer of private credit giant Ares Management, told a conference hosted by Bank of America Corp. last week.

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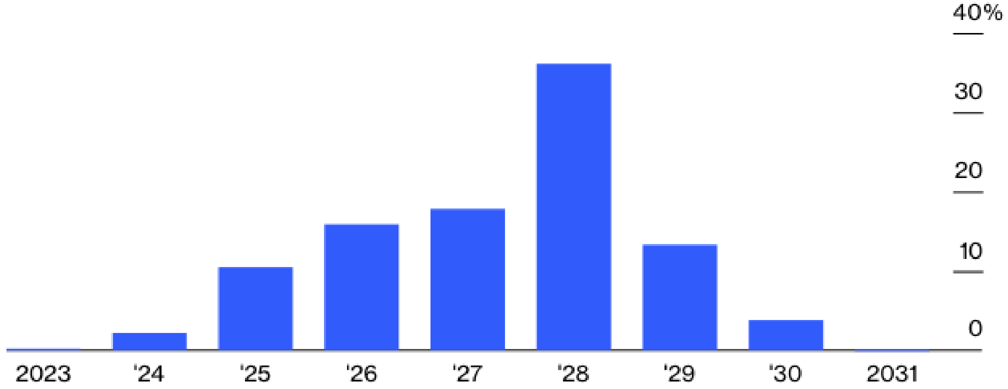
Near-Term Maturity Breather

The bulk of US leveraged loans mature after 2025

■ Morningstsar LSTA US Leveraged Loan Index maturity breakdown



Source: Eaton Vance, Pitchbook LCD
Note: maturity breakdown excludes defaulted facilities and is based on par amount oustanding

Most PE-backed firms don't have loans that require refinancing imminently. Plus there's another – less reassuring – explanation for the paucity of defaults: nowadays most LBO loans are so-called covenant lite, meaning they contain fewer hurdles for borrowers to trip over, providing they keep paying interest. Of course, the danger for creditors is that by the time a borrower defaults, the PE owner has shifted the best assets out of lenders' reach and the company is in such a pickle that credit recoveries are lower than they otherwise would have been.

Fewer Protections For Buyout Lenders

The vast majority of leveraged loans are now covenant lite

■ Covenant lite loan issuance as % of total leveraged loan issuance

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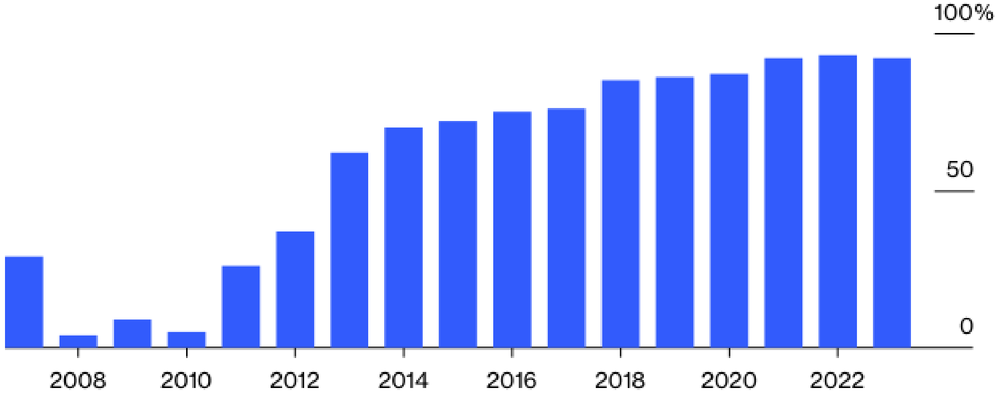


Source: Pitchbook LCD, Apollo Chief Economist
Note: data as of June 30

The main focus for PE firms and their lenders now is on liquidity, cash flow and interest coverage - the degree to which a company's adjusted earnings exceed payments on their debt.

These buffers are shrinking and, for a subset of lower-rated borrowers, remedial actions like cost-cutting and slashing capital expenditures might not be enough to cover their financial obligations.

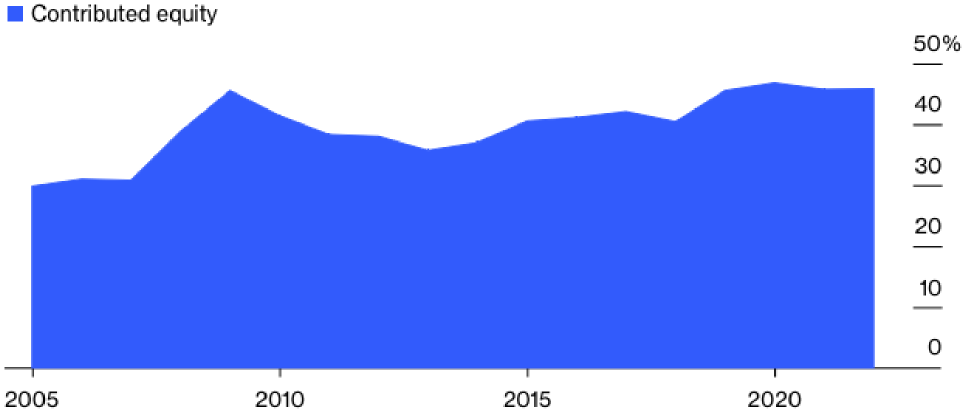
A recent Moody's survey of more than 300 North American B3 (six notches below investment grade) rated borrowers – many owned by private equity – found more than half would be unable to offset interest payments and capex with earnings by the end of 2023.

interest payments and capex with earnings by the end of 2023. Interest payments by this group would in aggregate consume an extra $16 billion of cash flow this year, Moody's said, meaning only a quarter of them will remain free-cash-flow positive (compared with nearly half last year). Chemical companies are expected to be among those worst affected due to shrinking customer demand. [1]

Financial sponsors may be willing to inject more money to prop up such businesses. PE firms were obliged to write larger equity checks at the height of the LBO boom, so their investors have more to lose.

More Equity in Leverage Buyouts

Equity checks for LBOS have increased to more than 45% of total financing



Source: American Investment Council
Note: contributed equity is equity provided by LBO sponsors. Does not include rollover equity.

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“If you're a financial sponsor and you have a company that's tight on liquidity, but you think… you're sitting on an equity investment with substantial value, it's obviously in your own self-interest to put some additional capital in to buy some time, particularly if you think rates are going to go down,” Craig Packer, co-president of private credit firm Blue Owl Capital Inc., told investors in August. “And that's why you're not seeing a real pickup in defaults. The sponsors are solving the problem.”

Private credit investors are betting this equity cushion is sufficient to avoid a big financial hit if a borrower defaults.

PE firms are sitting on more than $2 trillion of dry powder, plus they now have racier options to fund a capital injection: so-called net asset value (NAV) loans enable a private equity firm to borrow against the value of the entire fund rather than an individual investment.

PE’s aversion to losing money is also likely to trigger more out-of-court debt restructurings. Moody’s expects more than half of defaults in 2023 will be distressed exchanges.

What could go wrong? Firstly, it's dangerous to assume that profits won't deteriorate. US health care – a sector once assumed to be immune to cyclical swings – has been hit by the pandemic, wage inflation and regulatory interventions; defaults have risen.

Furthermore, PE firms won't always support struggling investments, especially when the capital in an older fund has been exhausted and the equity value of the asset has significantly deteriorated. Even then, sponsors may avoid a messy bankruptcy by handing control to lenders - often the credit arms of rival PE firms.

The longer central banks keep interest rates at these high levels, the more PE-owned companies will get into difficulties. But you can count on PE to find ways to turn crisis into financial opportunity.

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