Business
The Big Take

Hedging Failure Exposes Private Equity to Interest-Rate Surge

Many buyout firms considered hedging against rising interest rates a waste of time and money. Their debt-laden companies are now paying the price.

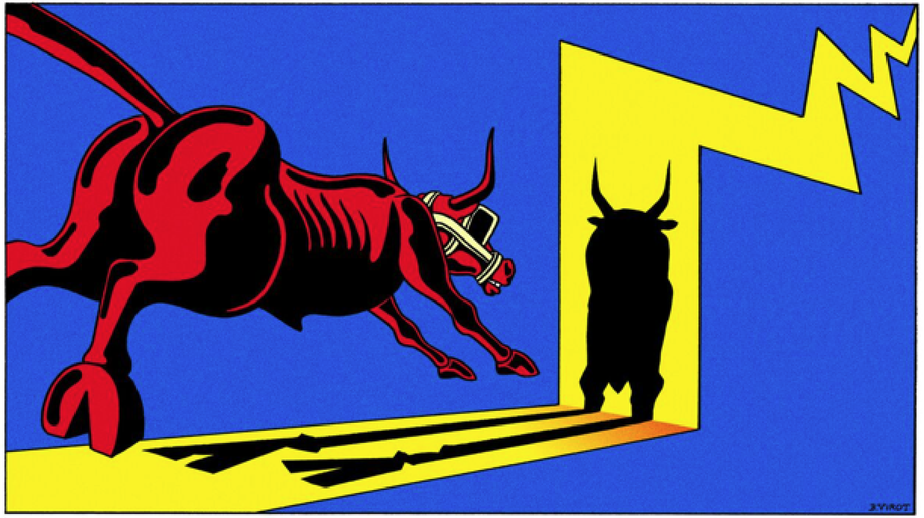


Illustration: Baptiste Virot

By Silas Brown, Abhinav Ramnarayan, and Paula Seligson
June 20, 2023 at 6:00 AM CDT

76.95 USD
▲ +1.93%

They're the gilded class of high finance, whose shrewd bets and jumbo-sized paydays are the envy of Wall Street.

Yet for all their savvy dealmaking, even the titans of private equity are getting caught out by the swift rise in interest rates – which is costing the companies they own billions in extra interest and threatens to push scores of them into default.

Lulled by a decade of cheap money and easy profits, boldface names like KKR & Co., Platinum Equity and Clayton Dubilier & Rice now face a reckoning of their own making.

By failing to appreciate just how much central banks would jack up rates, many private equity firms opted against hedging arrangements that could have shielded companies saddled with $3 trillion in floating-rate debt from rising interest costs, that in some cases, doubled or more. For much of the past decade, those hedges cost next to nothing.

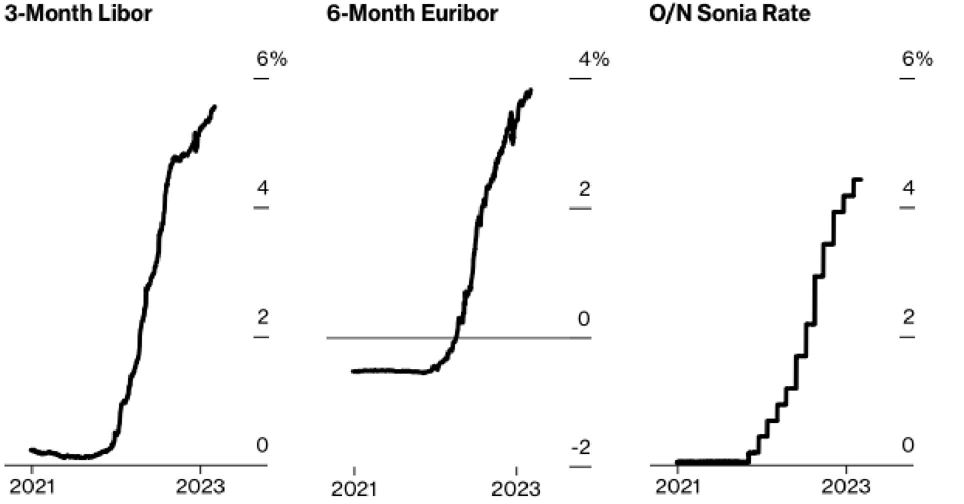
"Not many folks were worrying about this and a lot of businesses have been burnt really badly," said Chris Scott, Carlyle Group Inc.'s head of European capital markets.

Estimates are hotly debated and buyout firms across the industry declined to talk specifics. But in the US, nearly three-quarters of the floating-rate debt taken out during the leveraged-buyout boom lacked hedges as recently as August, according to an analysis by lacked hedges as recently as August, according to an analysis by Bank of America. Man Group Plc research suggests that over 70% of the total in Europe remained unhedged at the end of January, well after the European Central Bank began its tightening campaign.

Whatever the precise number, this much is clear: The consequences of rising rates for hundreds, if not thousands, of companies could be crippling, and the fallout widespread. Not only for investors, who face deep losses, or workers, who stand to lose jobs, but also the global economy, which could be upended if corporate defaults pile up.

PE-Owned Companies' Interest Costs Soar

Reference rates used to set borrowing costs on floating-rate loans have all jumped since 2022



director of credit at Man GLG, a unit of Man Group, the biggest publicly traded hedge fund. "Any downshift in earnings could be very painful."

The situation is the latest example of how Wall Street's best and the brightest – from bank executives to traders and economists – were almost uniformly blindsided by the pickup in inflation and how forcefully central banks around the world would respond to tamp it down. It's also a sharp reversal for private equity itself, which leveraged a flood of central bank money to finance a record number of buyouts at rock-bottom rates over the past decade.

A spokesperson for KKR said in an emailed statement to Bloomberg News that the New York-based firm takes a "prudent and thoughtful approach to hedging floating-rate risk" for all the companies that it owns. CD&R declined to comment, while Platinum didn't respond to requests for comment.

Like most businesses, private equity-owned companies have been weighed down by wage inflation, high energy costs and snarled supply chains.

Now, they're buckling under the strain of all the debt those firms used to buy them. Take Aventiv Technologies, which Platinum acquired in 2017.

The provider of phone services to US prisons, which has struggled to turn a profit in recent years, has been trying for weeks to complete a deal that would refinance two loans totaling about $1.3 billion and also repay $135 million of a revolving credit facility. Interest rates on the two loans, which are tied to Libor, have risen to around 10% and 13% based on current levels. That's at least 3 percentage points higher than at the end of 2021.

As a result, Aventiv's interest expense shot up more than 20% to $114 million last year, according to financial documents seen by Bloomberg News. That amounted to nearly half of its adjusted earnings before interest, taxes, depreciation and amortization, or Ebitda.

> Deeply indebted companies caught flat-footed without interest-rate hedges are having to play catch-up — albeit at a much greater cost

Across North America, interest costs at the median private equity-backed company ballooned to 43% of Ebitda last year, according to research published last month by Verdad Advisers, which analyzed 350 such companies that are either publicly traded or have publicly traded debt. Not only is that six times as much as the median S&P 500 company, but the interest burden will keep growing this year as

In fact, interest rates on the largest US leveraged loans (which simply refer to junk-rated loans which are often used to finance buyouts) hit an average of 10% this month, from 3.9% at the end of 2021, just before the Federal Reserve embarked on its most aggressive tightening campaign in a generation, based on the Morningstar LSTA US Leveraged Loan 100 Index.

The trend is the same in Europe, where policy makers have signaled that more rate increases are in store to fight inflation.

Many deeply indebted companies caught flat-footed without interest-rate hedges are having to play catch-up – albeit at a much greater cost.

According to Haakon Blakstad, chief commercial officer at Validus Risk Management, those businesses are discovering that they have to pay up to 200 times more to hedge than they did when interest rates were still low.

He estimates that hedging a €500 million ($546 million) loan in 2020 – with an interest-rate cap at 3% for three years – would have cost €50,000. Now, the same protection would run upwards of €10 million.

But because rates were so low for so long, many buyout firms, as well as the finance teams at the companies they acquired, considered hedging a waste of time and money. At best, Blakstad

Apple's iPhone and Watch Product Design Chief to Leave in Shake-Up

Stock Faithful Ride $7 Trillion Rally as Market Timing Backfires

Penn Leaders Out After Botched Genocide Answer, Alumni Pressure

considered hedging a waste of time and money. At best, Blakstad says hedging was often an afterthought, and often hastily arranged.

“Many private equity businesses didn’t have a centralized view on hedging,” Blakstad said.

That kind of complacency, Carlyle’s Scott says, has left companies needlessly exposed.

For example, all of the roughly £2.8 billion ($3.6 billion) of floating-rate debt owed by Wm Morrisons, a well-known UK grocery chain that CD&R acquired in 2021, was unhedged as recently as September, according to Moody’s Investors Service.

Morrisons eventually hedged 45% of that debt. Nevertheless, Moody's estimates that Morrisons would have still been on the hook for £375 million in interest on a pro-forma basis in its most recent fiscal year. That's a significant chunk of its £828 million in adjusted Ebitda over that period. Morrisons, which has struggled to keep prices as low as cheaper rivals amid soaring inflation in the UK, dipped into its revolving credit line to cover its costs partly because of the added expense, Moody's said.

Since then, worries about Morrisons' prospects have only deepened. Although Morrisons trimmed its net debt in the first quarter, unveiled a cost-savings plan and said its earnings may improve this year, Moody's cut its credit rating further into junk. Meanwhile, its €1.3 billion loan was recently quoted at about 85 cents on the dollar – near distressed levels.

MasMovil Ibercom, the Spanish telecom provider acquired by a consortium led by KKR, Cinven and Providence Equity in 2020, scaled back its interest-rate hedges right before central banks started raising rates, filings show. That year, the company had hedges covering €2.2 billion of debt, effectively all its floating-rate exposure. Yet by the end of 2021, that amount dipped to just €660 million, or about a third of its loans.

million, or about a third of its loans.

While MasMovil ultimately re-upped its hedges and remains in relatively good financial shape, its net interest expense still soared 50% last year as the ECB began tightening. KKR, Cinven and Providence declined to comment on MasMovil.

> Hedging was often an afterthought, and often hastily arranged

Of course, some have fared better than others. The European buyout team at Carlyle, for example, purchased contracts to cap the interest rate on roughly €10 billion of its companies' floating-rate loans at 0% when rates were nearing rock-bottom lows in 2021. One of those companies was Nobian, a Dutch-based maker of industrial salts and other chemicals. Carlyle bought caps that fixed the interest on its reference rate at zero from 2022 to 2024.

Overall, the firm estimates that its companies saved roughly €200 million in interest as a result.

The same is also true of Bain Capital, which also paid to cap its floating-rate debt at 1.5% to 2% for up to five years in mid-2021, said people familiar with the matter, who weren't authorized to speak

The same is also true of Bain Capital, which also paid to cap its floating-rate debt at 1.5% to 2% for up to five years in mid-2021, said people familiar with the matter, who weren't authorized to speak publicly. The decision saved the firm at least $2 billion, they said. A Bain spokesperson declined to comment.

"Very few firms were focusing on this as an area of risk," Scott said. "The market became complacent."

William Cox, senior managing director at KBRA, a credit-ratings firm that specializes in mid-sized companies and private debt, foresees a rash of defaults among corporate borrowers that are unhedged because they simply can't generate the cash flow to keep up with rising interest costs.

Leveraged Loan Yields Have Soared Since '21

Cox and his team analyzed roughly 2,000 private, medium-sized companies in the US. They estimate that in the current interest-rate environment – with many businesses facing all-in rates of 12% or more on their debts – over 300 of them will likely be unable to meet their interest payments and need to renegotiate their debts or seek financial lifelines from their private-equity owners.

For some, it's already too late.

Envision Healthcare, a medical staffing company owned by KKR, filed for bankruptcy last month, just one year after raising more than $1 billion in rescue financing.

In an early-morning press statement, the company, which employs some 21,000 people, rattled off a litany of problems that eroded its finances, everything from a sharp decline in patients because of shelter-in-place mandates at the outset of the pandemic and not being reimbursed by health insurers for services provided, to a shortage of clinicians nationally and a spike in labor costs.

Left out of the statement was the fact that the interest payments on billions of dollars worth of Envision's floating-rate debt were unhedged.

shortage of clinicians nationally and a spike in labor costs.

Left out of the statement was the fact that the interest payments on billions of dollars worth of Envision's floating-rate debt were unhedged.

The KKR spokesperson told Bloomberg News that Envision had interest-rate hedges in place until 2021. When they expired, Envision "was unable to find counterparties who were willing to take on the credit risk at a price that was not prohibitively expensive for the company," the spokesperson said in the statement. "It was simply not an option that was available to the company, given its circumstances at the time."

– With assistance from Sid Verma and Allison McNeely