Bloomberg

PE Firms' Dividend 'Epidemic' Intensifies Junk-Debt Alarm

By Matt Robinson and Sridhar Natarajan - Apr 22, 2014

Companies owned by private-equity firms are borrowing money to pay dividends like it's 2007, adding to concern among regulators that excesses are emerging in the riskier parts of the debt markets.

Borrowers including Madison Dearborn Partners LLC's mobile-phone insurer Asurion LLC obtained almost $21 billion in junk-rated loans this year to enrich their owners, the most in seven years, according to Standard & Poor's Capital IQ LCD. Some of the least-creditworthy companies are even selling notes that may pay interest with more debt, which BMC Software Inc. did for its $750 million payout to a group led by Bain Capital LLC.

With defaults by the neediest U.S. borrowers approaching record lows, buyout firms are taking advantage of the Federal Reserve's (FDTR) easy-money policies to extract payouts by piling more junk debt onto the companies they own. The central bank, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency have warned in recent months that underwriting standards for speculative-grade issuers are weakening as investors become more willing to accept looser terms.

Dividend Opportunity

"It's kind of like an epidemic," Martin Fridson, a New York-based money manager at Lehmann, Livian, Fridson Advisors LLC, who started his career as a corporate-debt trader in 1976, said in a telephone interview. "Once an investment banker sees that, he's going to go to his clients and say, 'Here's a window of opportunity, you can take a dividend and get away with it.'"

The amount of loans used for dividend deals this year is exceeded only by the pace in the start of 2007, when $31 billion was procured, according to S&P LCD. Investors are searching for yields as average borrowing costs on investment-grade debentures of 3.15 percent compares with a 10-year average of 4.85 percent, Bank of America Merrill Lynch index data show.

The payout for the Bain-led ownership group was financed entirely with $750 million of debt known as payment-in-kind notes, which enables Houston-based BMC Software to pay interest with extra borrowings instead of cash. More than $3.5 billion of such notes have been raised in 2014, also the most in seven years.

Junk loans are rated below Baa3 by Moody's Investors Service and lower than BBB- at S&P. A record $1.1 trillion of the debt was issued last year, according to data compiled by Bloomberg.

Rather than refinancing at lower interest rates or to fund expansion, dividend loans offer private-equity firms a way to recoup their investment while increasing the debt burden of the companies they control.

Adding Leverage

Leverage, or debt to earnings before interest, taxes, depreciation and amortization for U.S. speculative-grade borrowers tracked by S&P LCD, has risen to 5.2 times this month from 4.1 last April and the post-crisis low of 3.5 times in February 2009.

"Dividends are an easy way for a private-equity firm to quickly and efficiently monetize their investment and lock in returns for their clients," Frank Ossino, a Hartford, Connecticut-based money manager at Newfleet Asset Management LLC, said in a telephone interview.

Loan Yields

Asurion, which was taken purchased by Madison Dearborn, Providence Equity Partners Inc. and Welsh Carson, Anderson & Stowe LP in 2007, obtained a $1.7 billion loan last month to fund a payout to its owners, Bloomberg data show.

Companies have been pursuing dividend deals even as buyout loans increase. Acquisition financing accounted for 29 percent of the $20.5 billion in leveraged-loan issuance this month, rising from 20 percent of total borrowings in March, according to an April 11 report from JPMorgan Chase & Co.

The average yield on loans was at 4.8 percent at the end of last month from 5.2 percent a year ago, S&P LCD data show.

Bain and other buyout firms extracted a dividend out of BMC Software seven months after buying the computer-network software maker in September.

Platinum Equity LLC, a Beverly Hills, California-based buyout firm raised a $262 million payment-in-kind bond to pay itself a dividend a week after closing on its takeover of a rental unit from Volvo AB in February.

Borrowing Costs

Dan Whelan, a spokesman for Platinum Equity, declined to comment. Kate Schneiderman, a spokeswoman for Madison Dearborn at Abernathy MacGregor Group, declined to comment. Alex

Stanton, a spokesman for Bain Capital also declined to comment.

The window for borrowing at historically low rates may be coming to a close as economists estimate that yields on 10-year Treasuries will climb to 3.37 percent by the end of this year from 2.7 percent. The measure has increased from 1.7 percent a year ago. Yields on bonds tracked by the Bank of America Merrill Lynch U.S. High Yield Index have dropped to 6.05 percent. That compares with the 8.97 percent average over the last 10 years.

"Since a lot of people think Treasury rates will pick up in the second half of the year, it's a good time to borrow," Margie Patel, a money manager at Wells Fargo & Co. in Boston, said in a telephone interview. "The price is right for the borrower."

Fed Taper

The Federal Open Market Committee last month said it will reduce its monthly bond buying by $10 billion to $55 billion and reiterated plans to taper additional purchases "in further measured steps at future meetings." The committee announced $10 billion of reductions at its previous two meetings.

Default rates on speculative-grade companies have fallen to 1.7 percent in the first quarter, the lowest level since February 2008, according to Moody's. The credit rater expects that measure to rise to 2.4 percent by year-end, below the historical average of 4.5 percent.

Banking regulators in the U.S. updated guidance on lending to speculative-grade borrowers about a year ago, citing "deteriorated" standards and the willingness of investors to accept looser terms. The advisory also said underwriting standards should consider a borrower's ability to repay and "delever to a sustainable level within a reasonable period."

"The banks and sponsors continue to push the envelope because of continued demand for yield-generating products," Newfleet's Ossino said. "If someone's willing to lend to a company, it's difficult for borrowers not to accept the loan."

To contact the reporters on this story: Matt Robinson in New York at mrobinson55@bloomberg.net; Sridhar Natarajan in New York at snatarajan15@bloomberg.net

To contact the editors responsible for this story: Shannon D. Harrington at sharrington6@bloomberg.net; Faris Khan at fkhan33@bloomberg.net Faris Khan