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Guitar Center Purchase Hitting Wrong Notes for Underwriter

RETAIL: **JP Morgan finds no takers for $750 million bond to offset debt exposure.**

BY SARAH FILUS
Staff Reporter

Guitar Center's $2.2 billion acquisition was completed by Boston -based private equity firm Bain Capital in September, but underwriters on the highly-leveraged deal are fretting about whether they can unload some of their short-term bridge debt for the deal.

JP Morgan Chase, which provided a $1.8 billion loan to finance the deal, was trying to sell a $750 million bond to offset its debt exposure, but pulled it off the market last week because of the poor response it received from financial institutions.

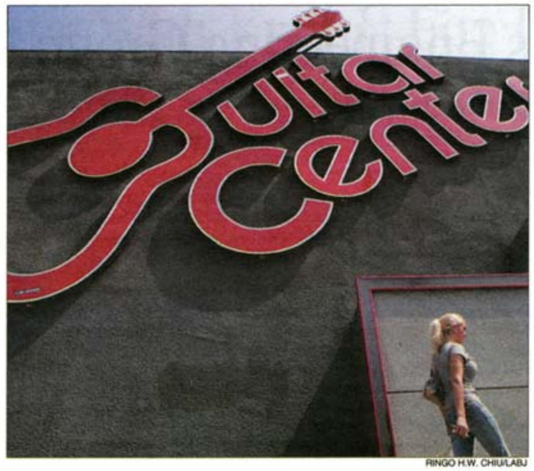
"This is a situation where the acquisition is completed using capital provided by JP Morgan Chase," said Lloyd Greif, chief executive of Los Angeles-based investment banking firm Greif & Co. "They stuck their neck out too far and bridged it, thinking they would be able to sell it later.

"JP Morgan said, 'Who wants it?' and people slammed the door in their face. If the high-yield notes remain unsold by the end of the post-acquisition marketing period, JP Morgan could get stuck with this additional debt exposure, which would not be a pretty thing."

The bottom line for Westlake Village-based Guitar Center and Bain could be higher interest rates and tougher repayment terms generally, Greif said. It is unlikely Bain would sell Guitar Center, largely because it likely would sell for much less.

The deal was agreed on in June before the credit crunch. The acquisition price was then considered a bit high, but is considered high now because of changed market conditions.

The struggling retail sector and the uncertain holiday season ahead also caused institutions to shy away from buying debt from the deal. The last Standard & Poor's report on Guitar Center before it went private said the company faces increased competition from instrument and online retailers, as well as such mass merchants as Wal-Mart and Costco.



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Strung Out: A woman walks past Guitar Center's store on Sunset Boulevard in Hollywood.

"Although Guitar Center has a history of robust growth and consistent margins, the company's recent operating performance has been hurt by the challenging operating environment of 2006 and 2007, and to some extent, by store cannibalization resulting from rapid expansion," the report said.

"Following its $2.2 billion purchase by Bain Capital, Guitar Center will be highly leveraged and have weak credit protection measures," the report continued. "We expect only minimal improvements of credit metrics in the near term given recent operating difficulties."

Greif put it this way: "Guitar Center might not be able to support the leverage in the long term. They sell guitars to professionals and hobbyists. In a struggling market, people might put off buying a new instrument and use the one they have. If that happens, it could have a steamroller affect on the company's financial performance."

If the company's performance falters, it may become increasingly difficult to repay its loans.

JP Morgan will most likely bring the bonds to the market again in the near future with more attractive terms for buyers, said Mariola Borysiak, an analyst covering Guitar Center for Standard & Poor's in New York.

"But it will probably mean higher financing costs," Borysiak said.

The fact that it will have a stigma in the market next time around as a blown deal will not be a particularly helpful selling point, Greif added.