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Dangers in Dividend Recaps

Are LBO players stretching too much for a second bite?

By Guest Writer
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Private equity firms, with the complicity of cash-laden lenders, are leading a growing number of companies down the garden path. And many of those companies won't have much time to smell the roses along the way. The problem is not acute at the primary deal level, where structures actually have gotten more conservative over the years, but among the less visible, leverage-dominated recaps designed to generate big tax-favored dividends without selling a portfolio company.

The greed factor has kicked in as lenders see that they can collect fees not just once or twice but sometimes several times from refinancing leveraged buyout deals and funding dividend recaps over and over again.

The current buyout binge by private equity investors has been duly noted in the press. Tales of these firms realizing hundreds of millions of dollars from a single deal aren't uncommon. But lost in this flurry of publicity is the fact that the financial health — often the very survival — of many companies is being jeopardized by the overreaching of private equity firms in the recap stage. Lenders that are more than willing to provide generous, reasonably priced debt financing for these deals are helping to engineer the recaps but posing a threat to the country's banking system and, perhaps, the overall economy.

One might argue that the buyouts being completed today are more sturdily structured than those of the 1980s. In that heyday of the leveraged buyout, deals were consummated with nominal equity provided by buyers. Banks and institutional lenders were putting up as much as 90% to 95% of the purchase price; private equity firms were cutting themselves in for as little as 5% to 10% of the upfront investment.

Today, those percentages are much different. Typically, PE investors are putting up 25% to 40% of the purchase price. Lenders are comfortable in financing the balance, which usually is a much smaller percentage than they were providing two decades ago.

So why worry? Because the recaps represent a basic change in the modus operandi of equity investors. The allure of quick money is enticing these players to bail out of their equity positions much sooner than they did a decade or two ago. Within 12 to 18 months after buying into a company, they are going back to their lenders and obtaining additional loans, further leveraging the company's balance sheet, and using the proceeds to pay themselves huge dividends equal to 100% or more of their original investment.

Thus, if a private equity firm pays itself a dividend equal to the cost of its investment, the debt-to-equity ratio would be infinite. And, obviously, a negative ratio would result if equity investors took out more than they had put into a company.

The reason private equity firms are cashing out much earlier is that they no longer have to sell or take their portfolio companies public to achieve the desired returns and liquidity. A tactical shift was engineered by a 2003 change in the federal tax law that applied the capital gains tax rate to dividends. Before then, any dividends from portfolio companies were taxed the same as ordinary income — an obvious depressant on returns without a complete exit.

Now, with the capital gains rate at just 15%, which kicks in after a one-year period for holding the investment, private equity firms usually can recapture their investment in a company in one fell swoop through a dividend recapitalization that leaves their equity ownership untouched.

Private equity firms' ability to take multiple bites of the apple results in large part from the intense competition for their business by banks and mezzanine lenders. Just a few years ago, lenders seldom were advancing more than two to three times cash flow, a conservative multiple. Now, it's not unusual to be able to obtain debt financing of five to six times cash flow in an LBO.

So an equity firm's choice of a lender to finance a big dividend usually depends on which one will lend the most cash and offer the most favorable interest rate and repayment terms.

Under such circumstances, a PE firm arguably has less incentive to encourage a portfolio company to grow and prosper. It might be able to take the company public,

but the cost of complying with Sarbanes-Oxley requirements doesn't make an IPO as attractive an option as it once was.

So the re-leveraged company is left laboring under a backbreaking burden of debt. If everything goes well, the company should survive. But almost invariably there will be hiccups. If sales decline because of a downturn in the economy, if a new product line doesn't perform well, or if a competitor comes along and takes a big bite out of market share, suddenly the company can't cope and still service its over-sized debt burden. Another risk is a sharp uptick in interest rates because the bank financing that underpins dividend recaps typically is floating rate debt.

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Under that scenario, the private equity firm finds itself in a position similar to that of a homeowner who has refinanced a mortgage one time too many. If the value of the house declines to the point where the owner no longer has any equity in it, his or her reaction usually will be to abandon it. Caught in a similar bind, there's nothing to prevent a private equity firm from walking away by putting the firm into bankruptcy and saying to the bank, in effect, “Here are the keys. It's all yours now.”

Where does this leave the banks? After the private equity investors take their money off the table in a deal, the company is 100% leveraged and the banks are the only ones that still have a stake in it.

Obviously, if enough private equity deals turn sour, there could be a severe strain on the banking system. Worse yet, there likely would be a ripple effect through-out the economy as companies declare bankruptcy or, at best, tread water and forgo expenditures to fund growth. They won't be able to invest in new plants and equipment or new products because all of their earnings will be diverted to pay off debt.

The net result could well be a jolt to the system that is manifested in widespread layoffs, swelling the rolls of the unemployed.

All of this may seem like a doomsday scenario to some, but it's far from inconceivable.

What, then, can be done to avert such a calamity?

First, all of us in the fields involved here — investment banking, commercial banking, mezzanine lending, and private equity investing — must look beyond the fact that these are very good times for us. We have to realize that we have a social responsibility to exercise discipline so that things don't get out of hand, as they have in previous LBO cycles.

The lenders bear a disproportionate share of this burden because they're the ones who are aiding and abetting the problem. The greed factor has kicked in as lenders see that they can collect fees not just once or twice but sometimes several times from refinancing leveraged buyout deals and funding dividend recaps over and over again.

If we don't take preventive measures, the government may step in. At present, of course, private equity investing lies outside of the purview of government regulation. But if the government sees the situation tumbling into chaos, it could attempt to extend its reach to include the private equity arena.

Some might contend that a self-disciplining system already exists. If a private equity firm should disappoint the institutional investors and high-net-worth individuals who back its funds, those investors will withdraw what's left of their capital, if possible, and refrain from investing in future funds of that firm.

But that time-delayed, after-the-fact self-policing system will kick in too late to prevent lenders from suffering big losses when deals don't work out and employees lose their jobs at over-leveraged companies that have gone bust. So it's imperative that all parties involved in highly leveraged deals work together to guard against the day when we may have to admit that Chicken Little was right.

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