Institutional Investor

Debt Done Gently

Private equity firms are cautiously turning to dividend recaps to bolster liquidity.

•• BY XIANG JI

MICHAEL PSAROS loathes the idea of being a seller these days. The co-founder and managing partner of New York turnaround investor KPS Capital Partners says the traditional exit channels — that is, the selling of private equity deals — remain singularly unattractive. Even after a three-year slump, the sector shows few signs of a turnaround.

A number of KPS's portfolio companies, such as East Alton, Illinois–based Global Brass and Copper, are well positioned to fetch a handsome price once the economy comes back, he says. A few years back, KPS, which has $2.6 billion under management, created GBC from a carve-out of Olin Corp.'s metals division for $400 million in cash. Intent on getting a good price and gaining some liquidity, Psaros, now 43, turned to a maneuver known as dividend recapitalization.

Dividend recaps occur when a company takes on new debt to pay out a special dividend to private investors or shareholders. The upside is the payout; the downside is the high leveraged debt, which increases the chance of bankruptcy.

In August, GBC issued $465 million of new debt, of which $102 million was used to issue a cash dividend to shareholders — KPS is the majority shareholder and together with company management holds 100 percent of GBC — and the rest to refinance its outstanding debt. Earlier this year, GBC issued a $100 million dividend funded directly from GBC's cash flow. With the two dividend distributions, KPS has returned its equity investment plus a tidy profit, says Psaros. "While we wait to sell our portfolio companies, dividend recap is a great way to provide incremental liquidity to our limited partners and our fund," he adds. Psaros declined to provide specifics.

Dividend recaps have become a viable means of adding liquidity as private equity firms face a prolonged dry spell. Blackstone Group, Madison Dearborn Partners and D.E. Shaw & Co. are among the many firms that have obtained liquidity through such deals. In total, dividend recap volume rebounded to $10.5 billion during the first two quarters of 2010, compared with $900 million in 2009 and $2.7 billion in 2008. To be sure, dividend recaps kept many deals in motion, given that realized exits for private equity firms during the first two quarters of this year were just $48.6 billion, according to data tracker Dealogic.

Compared with those done at the peak of the equity bubble, today's dividend recaps are tamed lions. Aside from a number of deals leveraged at more than 5 times ebitda, or earnings before interest, taxes, depreciation and amortization — the most leveraged deal: Blackstone's AlliedBarton Security Services' $111.5 million recap done in August, leveraged at 6.1 times — the vast majority of the 50 or so deals this year are modestly leveraged at below 5 times ebitda. Moreover, most dividend recaps are financed by the bank loan market, with strict covenants, rather than the loosely structured pay-in-kind notes used three years ago. "Deals are done at a leverage ratio that makes more sense," says Rod Miller, a partner at New York–based law firm Weil, Gotshal & Manges, who has worked on more than a dozen dividend recap deals in his 17-year career. "Since most of this recent batch of deals has been financed with first lien bank debt, private equity owners have to make calculated decisions to balance the risk and their liquidity needs."

"Dividend recap is a great way to provide incremental liquidity."

— Michael Psaros, co-founder, KPS Capital Partners

In comparison, private equity firms were able to claw back their investments through dividend recaps much faster during the boom. Many of those companies ended up dangerously leveraged at 7 to 8 times ebitda after recap deals, and some didn't survive.

There's no doubt dividend recaps increase the chances of restructuring, says Weil's Miller. But KPS's Psaros argues that appropriately leveraging companies — many of which KPS salvaged from bankruptcy with zero or little debt — shields the companies from huge tax bills. Philip Canfield, principal at GTCR Golder Rauner in Chicago, an $8 billion-in-assets private equity firm, agrees. "When there has been significant value creation in a company," he says, "dividend recaps can be ideal to leverage it up to an appropriate level." GTCR, it should be noted, hasn't done a dividend recap deal in the past three years. None of the firm's portfolio companies are sufficiently "mature and seasoned," says Canfield. Wise words. ••

*Comment? Click on **Banking & Capital Markets** at institutionalinvestor.com.*