Box 3

IMPACT OF THE CREDIT MARKET TENSIONS ON LBO ACTIVITY

In 2005 and 2006 private equity-based leveraged buyout (LBO) takeovers of euro area companies surged to unprecedented highs. This development helped fuel the boom observed in recent years in M&A activity more generally, which contributed to the strong acceleration of non-financial corporate loan growth in the euro area. In recent months, however, LBO activity has slowed considerably in the context of an ongoing reappraisal of risks and as a result of tensions in global credit markets. Those tensions have, inter alia, affected markets for securitisation and structured finance (such as collateralised loan obligations), which have in recent years contributed to the provision of cheap funding for LBO transactions, with banks able to easily offload even highly leveraged loans. This box examines the impact of the credit market turbulence on LBO activity and the potential effects on the growth of MFI loans to enterprises.

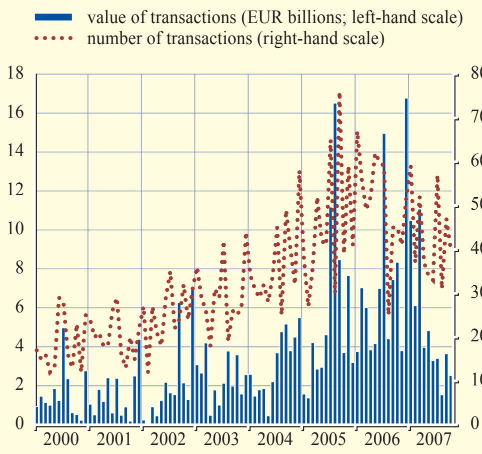
Developments in LBO activity

The latest figures for euro area-based LBO transactions indicate a marked decline in both the value and number of transactions over the past three months. Thus, the average monthly value of LBO transactions has, since end-June 2007, been only €2.9 billion, compared with an average monthly value of €6.6 billion over the preceding two and a half years (see Chart A). LBO activity has also decreased in recent months in terms of the number of transactions, reaching a level close to that prevailing in 2003 following a busy period of deal-making over the past two and a half years.

The decline in LBO activity is probably related to both supply and demand factors. On the demand side, the increase in credit spreads observed since June 2007 may have contained the demand for loans for LBO transactions. Since June 2007 credit spreads have increased across all rating classes, but spreads for less creditworthy borrowers (such as highly leveraged bought

Chart A LBO transactions in the euro area

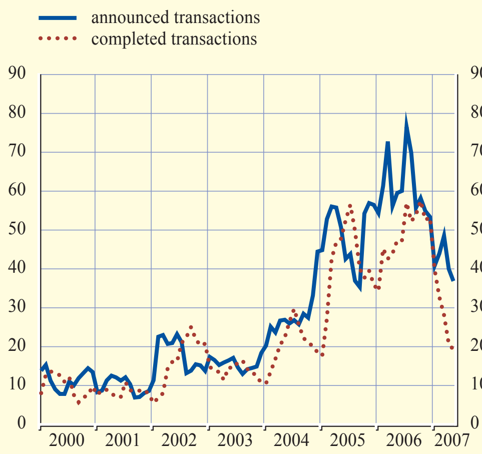
(monthly data)



Source: Bureau van Dijk (Zephyr).

Chart B Announced and completed LBO transactions in the euro area

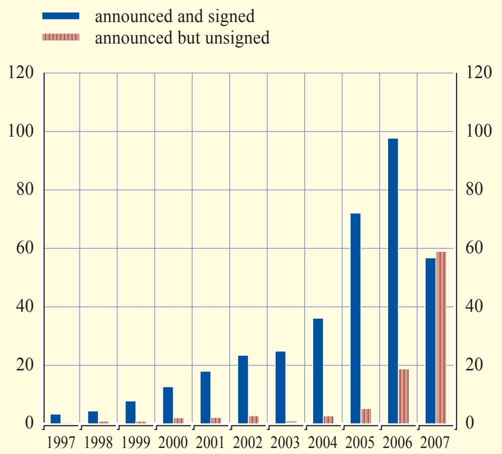
(monthly data; EUR billions; six-month moving totals)



Source: Bureau van Dijk (Zephyr).

Chart C Leveraged loan agreements in the euro area

(monthly data; EUR billions)



Source: Dealogic Loanware.

out corporations) have, in particular, risen significantly from the historically low levels observed over the past two years. Thus, between end-June and 7 November 2007 euro area high yield bond spreads increased by around 160 basis points (compared with an increase of only 40 basis points for BBB-rated non-financial corporate bond spreads over the same period).

The decline in LBO activity is likely to be closely linked also to the fact that, following the recent credit market tensions, banks are facing increasing difficulties in secondary loan markets when trying to offload loans related to LBO transactions for which they have, in the preceding months, already promised to provide finance.

By way of illustration, Chart B indicates that, on the basis of past experience, "completed deals" can be expected to peak around three to four months after "announced deals". However, in recent months the value of completed deals has declined markedly, despite the substantial value of the deals announced earlier in 2007. Thus, the total value of completed deals for the six months to October 2007 was a mere €19 billion, compared with a six-monthly average of €40 billion for the period since the beginning of 2005. At the same time, the total value of announced deals for the six months to October 2007 was only €37 billion, compared with a six-monthly average of €50 billion for the period since January 2005.

The impact on the banking sector

The significant decline in the value of completed LBO deals in recent months may, in part, be due to growing difficulties in raising financing, as reflected in the increasing number of announced but unsigned leveraged loan transactions observed in the course of 2007 (see Chart C). Thus, announced but unsigned deals as a percentage of total announced deals (i.e. signed and unsigned announced deals) has reached almost 60% in 2007, compared with an average share of 15% in the ten preceding years. This could, among other things, reflect the fact that initiators may in some cases have withdrawn from previously announced transactions in the light of the increased financial market uncertainty and the ongoing reappraisal of risk observed over the past few months. In addition, it might also reflect the fact that euro area banks have in recent months faced increasing difficulties in offloading a substantial part of these leveraged loans from their balance sheets and may, therefore, have become less willing to sign new loan agreements as issuance in leveraged loan markets has stalled and compounded pre-existing concerns about the ability of the markets to absorb a large pipeline of LBO-related debt.

A recent survey on banks' LBO business conducted by the Banking Supervision Committee showed that banks regarded the warehousing (or underwriting) risk as the most important source of risk in this business segment. Among other things, the survey indicated that it can, in general, take up to four months following the finalisation of a loan agreement before banks have fully distributed their leveraged loan exposures.[1] Against this background, it may be noted that, according to deal-by-deal data from Dealogic Loanware, in the period from January to September 2007 euro area banks agreed to provide financing for LBO transactions with a value of around €84 billion. In the light of the recent credit market developments, euro area banks may have had to hold onto these loans for longer than expected.

A considerable amount of leveraged loans that cannot be offloaded or that have to be sold at a discounted rate, combined with a rise in the default risk of highly leveraged firms, could put downward pressure on the earnings and capital ratios of banks which are active in LBO financing and thus exposed to the leveraged loan market. In fact, in an interim period, where banks have to hold onto those loans, they may face capital constraints, given the size of their exposures, and may, therefore, have to reduce lending. The October 2007 Eurosystem bank lending survey indicated that loans for large M&A transactions are more likely to be affected by tighter credit standards in the fourth quarter of 2007.[2]

It is highly likely that the surge observed in LBOs and other M&A-related transactions over the past three years has contributed to the strong growth witnessed in lending to non-financial corporations in the euro area. Thus, a slowdown in LBO activity and other M&A-related transactions may be expected to contribute to more moderate growth in non-financial corporate lending by euro area MFIs over the coming months, together with the impact of generally tighter financing conditions. However, the fact that many euro area banks may be having to hold onto already agreed leveraged loans for a longer than expected period of time, being unable to "re-intermediate" those loans at present, could have placed some upward pressure on MFI loan volumes in recent months, in addition to the effects of corporate loan demand (see also Section 2.1).

1 See also the article entitled "Leveraged buyouts and financial stability" in the August 2007 issue of the Monthly Bulletin.
2 See the box entitled "The results of the October 2007 bank lending survey for the euro area" in the October 2007 issue of the Monthly Bulletin.