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LBO Firms Use Ice Cream Recipes, Toy Stores for Low-Cost Bonds

Leveraged buyout firms, dependent since the 1980s on high-yield bonds, are finding cheaper financing for takeovers: debt tied to assets ranging from toy store leases to ice cream recipes.

When Bain Capital LLC, Carlyle Group and Thomas H. Lee Partners LP bought Dunkin' Brands Inc. for \$2.43 billion in December, they shunned the junk bond market. Instead, they took fees paid by Dunkin' Donuts store owners and by makers of Baskin-Robbins ice cream and packaged them into so-called asset-backed debt. The annual interest is \$38 million less than the amount the firms would have paid on junk bonds.

By pledging their royalty payments, rental bills, car leases and other assets, borrowers that historically raised money in the junk bond market can sell bonds with AAA ratings, just like General Electric Co. While LBO firms sold \$9.9 billion of high-yield bonds in the past six months, they issued at least \$5.9 billion of asset backed debt, according to Standard & Poor's LCD and Bloomberg data.

"This will be a standard tool in the LBO tool kit," David Heike, chief U.S. credit strategist at New York-based Lehman Brothers Holdings Inc. said in an interview last week. "You've got this big wave of LBOs now, and during the big one in the '80s this tool was not available."

"Really any assets that generate predictable cash flow" can be used to create securities, said Heike, Institutional Investor magazine's top-ranked analyst of asset backed debt. "Those are the same kinds of companies that LBO shops will be going after."

Kohlberg Kravis Roberts & Co., which depended on Michael Milken and Drexel Burnham Lambert Inc. to sell \$8.5 billion of junk bonds to bankroll its record \$31 billion buyout of RJR Nabisco Inc. in 1989, has turned to the asset backed market.

Leases, Car Payments

New York-based KKR, Bain in Boston and Vornado Realty Trust of Paramus, New Jersey sold bonds derived from leases on toy stores to help pay for their \$6.6 billion takeover of Toys "R" Us Inc. New York-based Clayton Dubilier & Rice led a group that sold notes tied to car payments to help fund its \$15 billion LBO of Hertz Corp.

LBO firms sold 22 percent of the \$115 billion in junk bonds issued last year, according to Morgan Stanley. So far in 2006, that percentage has fallen to 16 percent, even as private equity firms acquired companies at a record pace, according to the New York-based firm. High-yield bonds are rated below Baa3 by Moody's Investors Service and BBB- by Standard & Poor's.

Asset backed bond sales topped \$1.1 trillion in 2005, up 22 percent from the previous year and double the amount sold in 2003, according to the Bond Market Association, a Washington-based industry trade group that represents dealers.

M&A Twist

"Structured finance has been around for 20 to 25 years, but the M&A twist has been recent," Henry Morriello, a partner at law firm Kaye Scholer LLP in New York, said in an interview last week.

Borrowers obtain a higher rating for the bonds by providing more assets than would be needed to meet debt payments. Issuers can also insure their debt to reduce risks for investors.

"It's a very cheap way of financing," said Nasri Toutoungi, who oversees \$23 billion of bonds at Hartford Investment Management Co., a unit of insurer Hartford Financial Services Group Inc. "The market is receptive to those types of transactions."

Toutoungi, who spoke in an interview from his Hartford, Connecticut office last week, said he bought the Dunkin' Brands bonds and expects more leveraged buyouts to be financed with similar types of securities.

Officials at the buyout firms either declined to comment or didn't return calls for comment. Carlyle is based in Washington and Thomas H. Lee has its headquarters in Boston.

Record Year

Buyout firms, which acquire companies by using a small amount of their own cash and borrowing the rest, have announced a record \$184 billion of takeovers this year, Bloomberg data show.

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During the LBO wave of the late 1980s, the asset-backed market was in its infancy, forcing firms to rely primarily on bank loans and junk bonds.

And when the junk bond market crashed in the early 1990s, sending average yields above 18 percent in 1991, many LBOs were shelved. The amount of money raised by buyout firms fell to \$2 billion in 1991 from \$6.7 billion in 1990, according to London-based **Private Equity Intelligence Ltd.** About \$207 billion was raised last year.

Asset-backed bonds give buyout firms more options in case of another slump in the high-yield market.

Higher Yields

"We see it as a very significant growth opportunity," Robert Krugel, managing director in structured finance at Lehman, said last week in an interview from his New York office. "Relative to traditional forms of financing such as bank debt and high-yield bonds, private equity firms can achieve a meaningfully lower cost of funds, greater leverage and fewer covenant restrictions."

Lehman underwrote the Dunkin' Brands and Hertz sales.

Pension funds and insurers like the securities because yields are often higher than they can get on similarly rated debt. If the borrower goes into default, the investors have a claim on the assets backing the bonds.

All but \$100 million of Canton, Massachusetts-based Dunkin' Brands' notes have AAA ratings from S&P and Moody's. The debt is insured by New York-based Ambac Assurance Corp.

The top-rated portion of the notes was sold at a yield of 5.78 percent, or 15 basis points more than the average AAA rated corporate bond, according to Merrill Lynch & Co. index data. Asset backed notes rated AAA yield an average of 5.57 percent, Merrill data show.

Dunkin' Brands is rated 13 levels lower, or B-. The typical bond rated B yields 8.3 percent.

New Company

Bain was able to sell asset backed bonds by placing franchise agreements on doughnut shops and intellectual property rights on ice cream from the company's Baskin-Robbins unit into a new company called DB Master Finance LLC.

Royalties from store owners are paid to DB Master and then used to make the interest and principal payments on the bonds. Dean Foods Co., the biggest U.S. milk processor, paid \$11 million for the rights to make and sell Baskin-Robbins ice cream. Dunkin' Brands reaped \$277 million in franchise and royalty fees in the year ended in February, according to S&P.

KKR's group helped finance the Toys "R" Us purchase by putting the company's stores into a new entity, which became the Wayne, New Jersey-based retailer's landlord. That allowed the new company to sell \$800 million of bonds backed by rent payments from Toys "R" Us.

"That's the beauty of it: Anybody who owns real estate can do this," Todd Sammann, a managing director in commercial real estate at Deutsche Bank Securities Inc. in New York, said last week.

Rate Comparison

The Toys "R" Us securities pay interest at 1.3 percentage points more than the three-month London interbank offered rate. Libor, a lending benchmark, is 5.32 percent. Toys "R" Us also has bonds that aren't backed by assets. The 7.625 percent note due 2011 traded yesterday at 84 cents on the dollar and yielded 11.9 percent, according to Trace, the bond-price reporting system of the NASD.

Companies that use bonds secured by mortgages may be able to borrow an amount equivalent to 10 times their cash flow because investors have a direct claim on assets, Sammann said in an interview. Borrowers can get six to seven times their cash flow selling bonds that aren't secured, he said.

Mergers and acquisitions may help push sales of commercial mortgage bonds to a record \$300 billion this year, up from \$253.2 billion in 2005, Citigroup Inc. forecast.

'No Picnic'

Blackstone Group LP, the New York-based manager of the world's biggest buyout fund, used floating-rate mortgage bonds to help finance its \$1.44 billion purchase last year of Dallas-based hotelier Wyndham International Inc.

"The commercial mortgage market seems to have a plentitude of capital available," Darrell Wheeler, global head of commercial-mortgage-backed securities strategy at Citigroup, said in an interview from his New York office last week.

"Obviously the early '90s was no picnic for our market, and the experience has impacted and restrained the commercial real estate market even until today," said Wheeler, the top-ranked analyst following commercial-mortgage-backed securities, according to Institutional Investor.

In the early 1990s, banks and thrifts posted real estate losses as the economy slowed. Commercial mortgage defaults caused more than 700 savings and loan associations to fail, leading to sales of almost \$900 billion of assets at less than half their book value.

Woonsocket, Rhode Island-based CVS Corp., the second-biggest U.S. drugstore chain, is financing its \$2.93 billion purchase of 700 drugstores from Albertson's Inc. through securities backed by leases on its stores. Albertson's is based in Boise, Idaho.

Hertz Buyout

Hertz, based in Park Ridge, New Jersey, in December sold \$4.3 billion of notes backed by rental cars to help finance its LBO. Hertz also received \$2.25 billion of bank loans and sold \$2.7 billion of junk bonds.

Hertz's junk bonds pay coupons ranging from 7.875 percent to 10.5 percent. The interest on its asset backed debt ranges from a fixed-rate payment of 4.93 percent to 25 basis points more than Libor, or 5.57 percent at current rates. The asset backed notes were sold through Hertz Vehicle Financing LLC, which owns the cars and leases them to Hertz.

``This is not going to work for every LBO, but we're extremely bullish about the opportunities," Lehman's Krugel said. ``As the capital markets have continued to grow and the level of securitization has continued to increase, there's greater acceptance."

[Source: Bloomberg, 13-Jun-2006](#)

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