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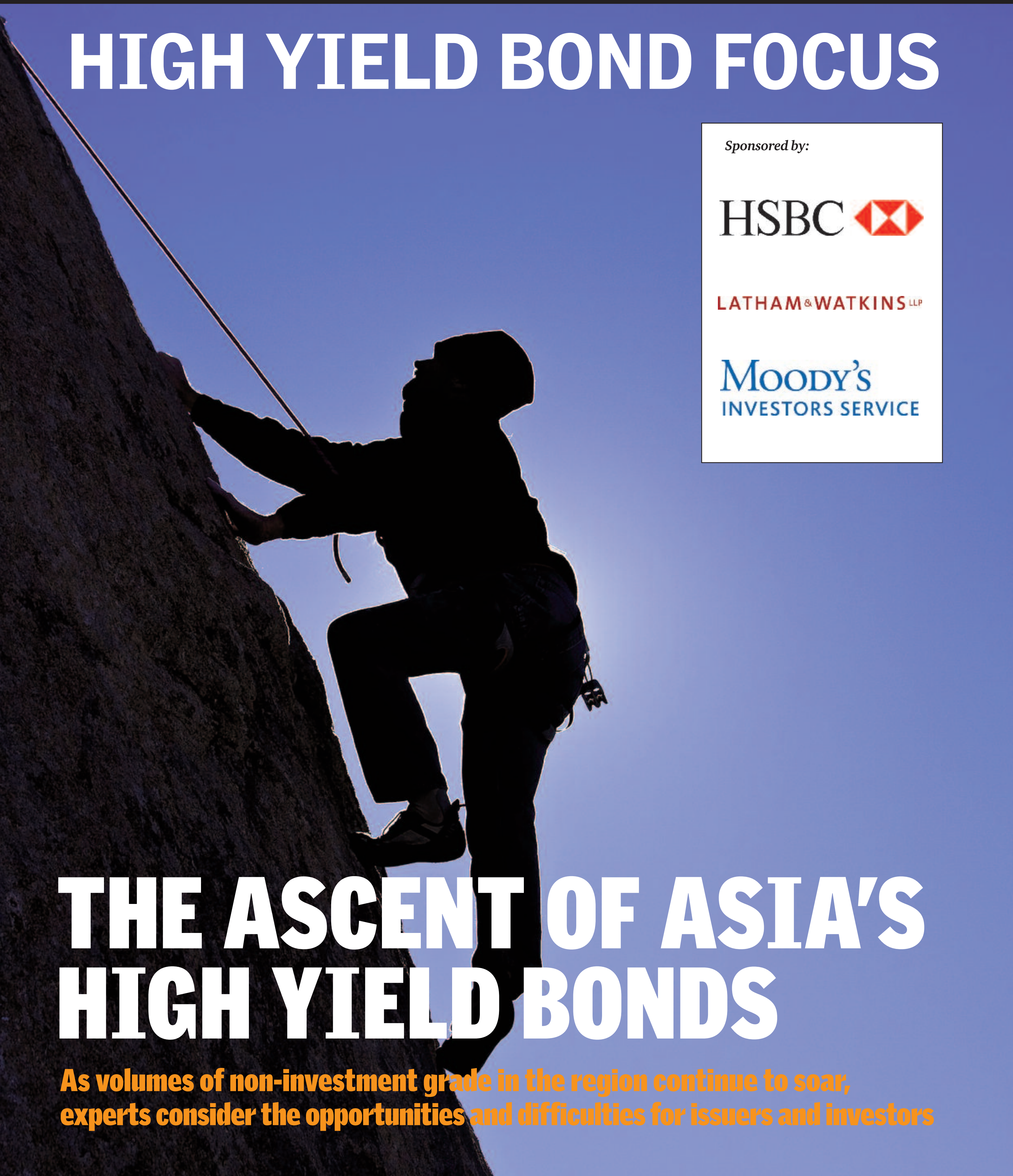
ASIAMONEY

- China's property bond persistence
- Looking to debt LBOs
- The slow extinction of covenants

HIGH YIELD BOND FOCUS



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THE ASCENT OF ASIA'S HIGH YIELD BONDS

As volumes of non-investment grade in the region continue to soar, experts consider the opportunities and difficulties for issuers and investors

Encouraging the evolution of LBOs in Asia

The region possesses more stringent covenants and less sophisticated structures when it comes to supporting the buyout efforts of private equity companies. Introducing a broader array of funding options will take time, but doing so will help improve the efficiency of companies and encourage competition for assets. ASIAMONEY speaks to a panel of experts about how they would like to see leveraged buyout financing evolve in the region.

MODERATOR: RICHARD MORROW, EDITOR, *ASIAMONEY*

LAURA ACRES, SENIOR VICE-PRESIDENT, MOODY'S ASIA PACIFIC

BRYANT EDWARDS, PARTNER, LATHAM & WATKINS

PATRICK LEUNG, FINANCIAL CONTROLLER, HONG KONG BROADBAND

IRWIN KEY WAY LIM, GROUP CHIEF FINANCIAL OFFICER, UTAC GROUP AND GLOBAL A&T ELECTRONICS

NICHOLAS MACKSEY, PRINCIPAL, BARING PRIVATE EQUITY ASIA

LAWRENCE (LARRY) WANG, MANAGING DIRECTOR, PRIMAVERA CAPITAL

Leveraged finance has long been a good source of revenues for bank lenders in Asia but, until recently, bond investors were not getting in on the act. That has now changed. Private equity funds or corporations looking for leveraged borrowing now have a plethora of options to raise the cash they need to complete Asian deals.

The bank lending market has certainly had its hiccups. The financial crisis scared some European banks out of emerging markets and made them run for cover back in their home markets. But that only forced Asian banks to become a bigger force in the leverage finance market, and once European banks had realised that sticking to domestic lending was a poor risk-return trade, they came back to Asian markets en masse. Combined with the increasing role of bond markets in providing leverage finance, there are now more opportunities than ever for Asian companies.

Not all markets were created equally, however. The fragmentation of Asian capital markets is clearly reflected in the appetite for private equity financing across the region. Singapore and Malaysia stand out as two countries with reliable legal frameworks and easy access for foreign investors.

But – as panelists on *Asiamoney*'s latest roundtable told us – in the region's two biggest economies, there is still a long way to go. Investors find it hard to get direct access to onshore entities in both China and India, and that is holding back the development of private equity financing in these countries.

It is clear, though, that things are looking good for private equity financing across Asia. The mix of investors, issuers and analysts on our panel may sound the occasional note of caution about the market, but they have plenty of reasons to be bullish. Bond investors have proved they are no longer limited to investing in refinancings or capital expenditure deals, banks are happy to boost their lending in the market – and companies and private equity funds alike are becoming increasingly hungry to make the most of these opportunities.

There could be few better times for *Asiamoney* to survey the landscape of the leverage finance market – and to find out what the next step is for a market that has plenty of room to grow.

ASIAMONEY* [AM]: *Private equity buyouts, particularly leveraged buyouts, have been popular in the US and Europe but less so in Asia. Why is this?

LAURA ACRES, MOODY'S (LA): The high yield bond market in Asia is relatively unsophisticated. It's still primarily a capital expenditure and refinancing market, so we're not seeing the number of dividend recap [bond issues] that you see in Europe or the LBOs [leveraged buyouts] that you see in the US. The market is still evolving.

The US high yield market 20 years ago would principally have been based upon capex and refi needs too. Over time we will see more LBOs financed through the bond markets in Asia. But for now it's the exception rather than the rule.

AM: ***Some of you here have done LBOs. Patrick, your company issued a US$450 million bond to refinance a bridge loan and to pay a dividend to yourself. Why did you adopt that structure?***

PATRICK LEUNG, HONG KONG BROADBAND (PL): We underwent a management buyout (MBO) sponsored by CVC Capital Partners 12 months ago. At that time the bond market was sluggish [amid the European debt crisis] and we didn't think a bond issue was a viable option to finance the MBO.

As a well-known brand in Hong Kong we were able to arrange a five-year term loan from a syndicate of 13 banks, which was a pretty good deal.

Later in 2012 the high yield bond market had turned around and eventually the coupon was so attractive that we started to think about whether to refinance the bank loans. The key problems with bank loans are obviously the financial covenants and restrictive terms. So we started preparation for a bond issue and were ready to go in December but the markets were not good so we finally did it in January. Getting such a favourable market response and coupon rate was a little out of our expectations. It was a totally different story versus nine months earlier when we arranged for the MBO.

BRYANT EDWARDS, LATHAM & WATKINS (BE): We've certainly seen an increase in interest in LBOs, and Hong Kong Broadband and Baring Private Equity are great examples of recent successful leveraged buyouts.

I agree with Laura that the Asia market is at an early stage. There are some cultural issues at play, as a lot of the very interesting businesses are family owned and they are not willing in many cases to sell control.

NICHOLAS MACKSEY, BARING PRIVATE EQUITY ASIA (NM): I would certainly agree with that. Generally private equity in Asia up until the last two or three years has been focused on minority or growth capital investment and there really weren't many [buyout] opportunities.

Since then scale businesses that could support LBO financing or access the high yield market have begun coming to market. Some businesses have been supported by self-made entrepreneurs and promoters who had built their businesses to sufficient scale. Other businesses were run by a family going through a generational transition and the next generation wasn't willing or able to step up so there was the ability and willingness to sell control.

AM: ***Lawrence, are you seeing a greater opportunity to do more LBOs than a few years ago?***

LAWRENCE WANG, PRIMAVERA (LW): I think at least the interest in Chinese LBOs listed offshore have seen a large increase over the past two or three years.

A lot of it has to do with valuations coming down. The Muddy Waters effect [in which the sell-side research company and competitors released disparaging reports about Chinese US-listed companies] has depressed equity valuations across all many Chinese sub-sectors.

That got a lot of Chinese founders and entrepreneurs thinking: 'If I'm trading at eight, nine, 10 times Ebitda [earnings before interest, taxation, depreciation and amortisation] this level looks attractive for me to take the company private. I can put a couple of turns of leverage

LAURA ACRES
SENIOR VICE-PRESIDENT,
MOODY'S ASIA PACIFIC

on the company, increase my shareholding, and perhaps come out in a couple of years in a more favourable market.'

We completed a transaction for a specialty chemicals company off the New York Stock Exchange two years ago and we used about a 50% debt-to-equity financing to take the company private. That transaction wasn't large enough to tap the high yield market so we used bank financing. Since then transactions have gotten larger, but valuations continue to be depressed. A lot of low hanging fruit has been picked up already but conditions are still there for this trend to continue.

BE: I think that the depressed values may spur more activity. A number of the family businesses we've looked at seem to be a hodgepodge of different businesses that don't make much sense together; there are

PATRICK LEUNG
FINANCIAL
CONTROLLER,
HONG KONG
BROADBAND

BRYANT EDWARDS
PARTNER, LATHAM & WATKINS

not a lot of internal synergies and often the assets would generate more value if they were broken up and sold to strategic or financial buyers.

In a way it's very much like the US in the 1970s when many large corporations were conglomerates with businesses in lots of different sectors. They didn't make much sense together, but it took the private equity firms, LBOs and high yield bonds of the 1980s to break them up and reassemble them into more logical structures.

I predict we will see many acquisitions in Asia as private equity firms and strategic buyers acquire the good but undervalued assets of family-owned Asian businesses and put them together in more efficient combinations.

NICHOLAS MACKSEY
PRINCIPAL, BARING PRIVATE EQUITY ASIA

AM: ***What levels of leverage can you typically attain in Asia versus Europe or the US?***

NM: Asia is probably one or two turns of Ebitda behind the more developed markets of the US or Europe. And certainly the tenor of financing is a lot shorter as well. While the bank market in Asia is developing and slowly getting there in terms of sophistication and comfort with LBO financing it's still a long way off in comparison with the developed markets.

In terms of senior leverage you're probably talking three to three and a half times [Ebitda], potentially an additional layer of mezzanine debt or stretch senior taking you to four times Ebitda, but you're still a full turn to turn-and-a-half off of what you'd see in the US or Europe.

In terms of tenor you're probably restricted to five years as opposed to six or seven you'd get in developed markets, and [here you have to accept] a higher level of amortisation and a more restrictive covenant package. The levels of restrictions that the banks impose here is certainly higher.

But the bank loan market can take the view that they will support a smaller scale of business as opposed to high yield, which is really only available to companies generating US$100 million plus of Ebitda before the high yield market really sits up and takes notice.

AM: ***What's needed to make banks a little happier to lend to private equity takeovers?***

NM: Competition. The worst thing that happened for Asian private equity was the financial crisis when the European and to some extent the US banks pulled out. The Asian banks were left to go back to their more conservative ways. That was definitely a negative from a leverage perspective because the European banks and the UK banks brought sophistication, aggression and depth to the market.

The Asian banks are by tradition more conservative, and that's probably why they have stronger balance sheets, but by the same token it's really the lowest common denominator you get left with [when seeking LBO funding] and when you're filling a book the market depth means the absolute size caps out. The most you can get in Asia without going to the high yield bond market is US$400 million to US$500 million and every last bank is in there.

AM: ***Irwin, Global A&T did a US$625 million bond earlier this year to help refinance a sizeable LBO you'd done earlier. Was it tricky to bring the banks in originally and simpler with the bond?***

IRWIN LIM, UTAC GROUP (IW): When we first did the leveraged buyout in 2007, the leveraged financing market was very good. In 2007 we had a leverage financing package [consisting of a revolving credit facility, a first lien term loan and a second lien PIK toggle floating rate note], arranged by three investment banks. The FRN was meant to be a bridge that would be refinanced by a bond issue but before the bond could be launched the Lehman Brothers crisis hit [in September 2008]. Subsequently portions of the FRN were sold out privately into the market.

For this round we did a refinancing of our first loan with a US$625 million high yield bond issue. Initially it was a bit of a challenge as we were a first time issuer and the amount we wanted to raise was quite large for an Asian technology company. To make things worse the bond market was weak when we went on our roadshow in November. This was just after the US presidential election and the market focus was on the fiscal cliff issue. We also realised that for a technology issue Asian investors still very much take their cues from their US counterparts. We had to postpone the deal as a result.

Fortunately the market turned back up quickly at the beginning of this year and we go the deal done in early February.

AM: ***Laura, are you seeing an increased number of private equity-linked issuers seeking ratings?***

LA: It's still a minority. We've certainly had a couple of deals come where people have expressed interest and go through rating meetings. But then because of some of the questions we're raising and feedback we're giving about where the rating is going to come out, which is typically at the lower end of the spectrum because of the leverage, these deals never go to market or never complete the rating process or we deliver the rating and it's never published.

AM: ***Which markets are most accommodating for private equity deals and LBOs to support them?***

NM: Singapore and Malaysia are both very accommodating to private equity transactions. Rule of law and security are always big issues. You get scale of business and growth in China but I think that the ability to get cash out of China and service loans is always a big issue. Security enforcement is a big concern.

Likewise with India having to finance these transactions offshore the lack of collateral makes it very difficult and it always reduces leverage appetite. If you need leverage for an India buyout it needs to be at the offshore level and then you can't provide upstream guarantees. So it's essentially the same as China.

LA: From what I've seen LBO deals are more sector-specific than country-specific. So from Korea and Taiwan it's very much the cable TV space [in which LBOs are conducted]. Out of Indonesia we're getting the tower space, the same with India. All these businesses have long term contractual revenues, so isn't it a case of once you have that then you can start to get comfortable with the other issues?

NM: Stability of earnings is key. You can look at a lot of sectors but anything you're going to put leverage into you want to know that they can service their debt. Our portfolio company that has accessed the high yield market is in the education space, very non-cyclical with a consistent earnings profile and that's been why we've been able to attract demand from high yield investors.

AM: ***Is that the case with Hong Kong Broadband?***

PL: I think as Bryant said earlier in Hong Kong the cultural factors may deter LBOs. Our case is quite unique; [CTI group chairman] Ricky Wong is truly entrepreneurial and he decided to sell the company because he has a big plan to build a multimedia empire. There were very special circumstances that made this LBO happen.

There are a lot of big families having conglomerate businesses and my view is that when the second or third generation of the family takes over the conglomerate there are more chances that they will sell down non-core assets. But now it's still in the hands of the first or second generation. It's part of the Chinese culture really not to sell their businesses unless it really goes very bad.

AM: ***I assume your business is quite predictable in its investments too?***

PL: Yes, we are like a utility company. Because we have a sticky subscriber base and we typically have a 24 month contract with the customer. So the business model is quite predictable, although there may be some ups and downs which are different from our plan. Relatively speaking, the broadband market is less competitive in Hong Kong [than some other industries].

AM: ***Are there other areas that are not too capital intensive, have predictable streams, and have not had much LBO activity yet?***

LW: We have looked at the cash flow generation of a lot of different Chinese companies and sectors, and not that many Chinese companies generate good cash flow. We've come across some better names in the online services, consumer products and media and entertainment sectors.

We focus on China, and a lot of companies don't manage their cash flow that well. They are still earnings driven and the equity capital markets still look at them from an earnings base. These companies are trying to get their net income up and don't care about how they manage their working capital and their capex spending, so the generation of cash from these businesses is not optimal. There are many things you can improve to get a better cash conversion from these companies.

AM: ***Is that something you can convince the companies and banks about?***

LW: It's tough for the banks to get comfortable with a company that lacks strong historical cash flow generation. In some sectors that process might be a little bit easier for the lenders to comprehend, but a lot of this has to do whether these will be sponsor-controlled or family-owned.

A lot of the time even if a sponsor owns over 50% the founder still pretty much operates the company. You've seen a few sponsored deals where founders step aside and let professional managers in but those are few and far between.

AM: ***Currently most LBOs are conducted with loans, with bonds sometimes used to refinance them. Given the conservatism of regional banks and a dynamic high yield market, could LBOs be directly financed by high yield bonds?***

NM: I think so, but again it's a scale issue. You need a business that's large enough to support a high yield bond issue. You need the sophistication at a target company to not only close an acquisition but immediately get on the road and market a high yield bond and that's still at a pretty nascent stage in Asia.

Right now the level of investor relations or outside reporting isn't quite there. As Larry mentioned even working capital is stage one, stage two is can you report and demonstrate to the market what your business is doing and explain how you're going to be able to service those loans and what the plans are for the business going forward. I think it will take more professional management to drive that.

AM: ***There must be an opportunity given that the covenants on the bond side are much lighter than they are on loans.***

NM: Covenant-lite or incurrence-only covenants [typically found on high yield bonds today] are certainly a lot more flexible and appealing compared with the bank loan market with very restrictive covenants and tight restrictions around acquisitions or capex . When you're in a high growth market the ability to execute on a business plan outside of tight restrictions is very appealing.

But you need to weigh that against the appetite and pricing. Bank pricing is still significantly tighter [in terms of yield and interest] but the cost of that pricing is still restrictions.

AM: ***Patrick and Irwin, your companies both did bonds to help pay off loans. Did doing so help free up the possibilities for your companies?***

PL: In the past our financial covenants were measured quarterly [by the banks]. There were [several] covenants that we had to be very careful when managing our business. Just a few months after the LBO this isn't a big issue, but it can become a headache when things don't happen that you expect. And you face having to comply with all these covenants and restrictive terms for years.

Right now we are very happy that we don't have those covenants or restrictive terms and can instead focus on growing our business. And, having taken the bank loans out with a bond, we have more flexibility in terms of our product development and service offerings, and have more flexibility in managing our capex plans, whereas under the bank covenant package we had substantially less freedom.

AM: ***Which covenants hemmed you in too much?***

PL: There were several key financial ratios, such as the net leverage ratio and debt service coverage ratios. They should be fine if your business is doing well, but over time may become a concern.

We also had covenants on our capex. Under the original thinking we intended to lower our capex over time because we already had a substantially invested citywide fibre network. But the covenant would restrict our growth plans, as it would limit our ability to grow if other opportunities arose. Given the bond market was so good in 2013 we really thought it was the right time to take out those bank loans.

IL: Just to second what Patrick said, definitely the big advantage of high yield firstly is the tenor, you can do a much longer period. Ours was six, we could have done between five and seven and could have gone further but pay a bit more interest.

Second is the covenants. Our industry is very cyclical in nature and having the covenants put us at great risk, so it's a good thing that for our high yield bond issue we only have lighter covenants such as incurrence covenants but not financial covenants.

AM: ***Do the stringency of covenants on a deal impact its rating?***

LA: These are two separate things. The rating is the rating; good covenants do not make a weak company a strong one.

In order to look at covenants quality we have what we call a covenant score. We take every high yield bond and look at six key risk areas [restricted payments; risky investments; leveraging; liens subordination; structural subordination; and change of control] and assign each one scores out of five, where five is the weakest and one is the strongest. The overall score is a weighted average of these. This allows for benchmarking and comparability across regions, sectors and ratings, and even the banks that brought the deals to the market.

If you look at that data on a trend basis, what we've seen this year in particular is the markets have been hot for bond issuance and covenant quality has deteriorated quite markedly. We have published charts that essentially show declining covenant quality in Asia.

Our ratings are very much based on fundamentals. We're looking at them from a bottom up approach, looking at operating performance, financial performance, the regulatory environment etc.

BE: One thing that surprises me is the inconsistency in the Asian market of covenant packages. You will see a structurally subordinated dim sum bond issued with hair trigger financial maintenance covenants put in place above an issuer with high yield bonds with typical high yield incurrence covenants. That is upside down. I think it would be helpful for the industry to develop a more consistent approach towards covenants.

NM: The high yield market has flexibility that you don't get in the bank market. But as Laura says a good covenant package doesn't make a good company. Fundamentally I think the high yield and bank market needs to look through the fundamentals of the business and see what financing package it can support. It so happens that our business's strategy is around acquisitive and organic growth and the package in place has allowed us to continue that growth and incur additional debt to help support that growth.

AM: ***Are regional high net worth investors big players in LBO bonds?***

IL: We got a lot of demand from Asia which quite surprised us. Roughly we were evenly split between US and Asia investors for our bond. There were also a number of high net worth investors keen to participate in our issue.

PL: We went for a Reg S only deal, taking the advice of our bankers to target both institutions and private bank clients, especially those in Hong Kong and Asia. At the end almost three quarters of the allocation went to Asia and the private bank clients accounted for about 45% of the allocation.

We succeeded because our brand name was really strong in Hong Kong so a lot of local investors knew our name, while the private bank clients were quite keen to have diversification.

AM: ***Softbank's recent high yield bond issue was an example of a major LBO-related deal. Does this demonstrate increased willingness to support more high yield deals?***

BE: Interestingly there was enough liquidity in the Japanese bank market to fully finance Softbank's US$20 billion bid for Sprint in the US, but Softbank wanted to have part of the financing be high yield bonds, partly due to its desire to develop its credit story and a following among international bond investors.

Softbank ended up raising US$3.3 billion through its bond offering, and the US dollar tranche was priced at 4.5% for a bond that will be downgraded to high yield upon the acquisition of Sprint. I think the strong investor support and remarkable pricing that Softbank achieved will give the Asian companies the confidence to raise substantial funds in the international market to finance bids for iconic US and European assets.

LA: That deal was helped by the sector it was in. Any telco bond deal over the past few years that has occurred has had substantial oversubscription and good pricing, in large part because there's been a lack of supply.

BE: In the Softbank case, the target Sprint has always been a frequent and active issuer of high yield bonds. The familiarity of investors with Sprint probably helped Softbank raise the funds it needed on such favourable terms.

IL: We found when tapping the US market it's a good idea not to be a first time issuer. A lot of high yield bond investors are not tech savvy and when you lack a history of cash flow generation capability it's quite difficult to convince people you can generate enough cash, particularly when you're an Asian issuer.

AM: ***Patrick, you used some of the proceeds of your bond as a dividend recap, which is quite unique. Was it tough to get investors behind that?***

PL: We did get a lot of questions from investors about the use of proceeds but they didn't really challenge it once the idea of right-sizing our capital structure was explained and they had received guidance on our dividend policy going forward. They weren't too worried as the dividend recap was not that big in our case.

The priority was for us to get rid of the covenants; paying out the dividend was secondary. We don't intend to pay out another dividend until we IPO the company.

AM: ***Will we see more such transactions?***

NM: I hope so. The first bond deal we did was two thirds refinancing of the original LBO debt and one third dividend. And we agreed to pretty tight ongoing dividends restrictions, and that was at the operating level with full guarantor coverage. Then earlier this year we completed a senior unsecured issue at the holding company level which was all dividend recap, that was a PIK [payment in kind] toggle issue [a bond issue in which coupon payments can be supplied in the form of more bonds instead of cash], which was the first of its type for Asia. We have since reinvested the proceeds of the PIK toggle issue into the business.

We still received good investor support because there's a pretty significant implied equity cushion. High yield investors look at hard dollars in whereas equity investors look at how much skin is in the game as opposed to how much money you've put in. That focus is a lot more accommodating to dividend recaps.

AM: ***Is the PIK toggle deal one that has opportunities elsewhere too?***

NM: For the right business with the right reason on why you need the toggle. It needs to be a very stable business and you need to have a strong intention to cash pay and the only reason why you would elect to PIK the interest would be credit enhancing. If you're using the cash to grow earnings and de-gear the business as opposed to just accruing the interest the high yield investors can get on board with that.

LA: With PIK toggle deals and recap dividend deals most of the investor base is towards the US. They seem to have a far higher tolerance for these sorts of deals.

AM: ***To conclude, what developments would you like to see that would make your job easier?***

NM: I hope to see increased appetite from banks in general as well as more willingness from high yield investors to buy Asian paper. There is still an apprehension about investing in Asian paper.

BE: I'd be interested to see policy breakthroughs, particularly in China, to allow more foreign investment. There appears to be increasing pressure on the Chinese banks and that, combined with a wall of international money that is interested in investing in good Chinese credits, should encourage policy makers to allow more flexibility in the restrictions on cross-border capital flows and in the restrictions against onshore credit support for offshore bonds. Policy breakthroughs like that would be very helpful to the Hong Kong and China bond markets.

PL: I'd support what Nicholas and Bryant said, about seeing a healthy development of the bond market to support corporate development across the region.

IL: What I'd really like to see is the domestic banks in the region become more sophisticated and provide more financing. Ultimately it's cheaper for the company compared to a high yield bond, which helps with interest payments. We also want banks to be more relaxed on the covenants. And we might do another bond sooner than later.

LAWRENCE WANG
MANAGING DIRECTOR,
PRIMAVERA CAPITAL

LW: I'd love to see the whole market deepen and become more sophisticated. There are a lot of real estate bond issuers, but we'd love to see other industries coming out to market.

LA: I echo Larry's point; we just need to see more issuance. The Asian high yield market is nascent and evolving; there is very little breadth of issuers and with the exception of Chinese property there is very little depth. I'd like to see more issuance and corporates in the market. ◢

IRWIN LIM
GROUP CHIEF
FINANCIAL OFFICER,
UTAC GROUP AND
GLOBAL A&T

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