The Leveraged Lending Environment: Not Without Feathers

Leveraged buyouts have been a primary source of liquidity for the middle market in recent years. Critical to the success of these transactions are capital structures that provide private equity firms with adequate rates of return. Unfortunately, over the past several years it has become increasingly difficult to assemble capital structures that make leveraged acquisitions attractive to their investors. The amount of debt available to fund an LBO (as a multiple of a target’s EBITDA) has fallen from an average of 5.0x in 1997 to 3.5x in 2001. The key reasons for this contraction have been a flagging high yield market and a restrictive senior debt environment. As a result, in order to finance transactions, LBO groups have turned to other, more expensive, sources of capital (greater use of mezzanine debt and, in particular, increased equity contributions) to bridge the gap. The implication has been lower expected rates of return for many investments. However, several converging factors are reason for increased optimism among participants in the LBO market: (1) indications of a strengthening economy; (2) a private equity universe flush with cash following several years of successful fundraising; and (3) a low interest rate environment with thinning spreads that is keeping interest expense in check.

Despite a decline in overall M&A volume in the first quarter of 2002 versus the fourth quarter of 2001, LBO loan volume increased by 81%. Moreover, while senior leverage remains conservative, leverage multiples (and, consequently, purchase price multiples) for high quality, non-cyclical businesses with strong growth prospects are becoming more attractive. Recently, several strong LBO candidates have generated proposed total debt/EBITDA ratios of 4.5x and above. Such transactions are consistent with overall market data that reveals for the first quarter of 2002, the percentage of leveraged loan volume with total debt/EBITDA of 4.0x or higher leapt to 48% from 25% in 2001. While the prognosis for the debt market remains uncertain, the increasing number of more ambitious capital structures (and valuations) is an encouraging sign.

DuPont Canada, Inc. (TSE: DUP.A) announced on March 27, 2002, that its Enhance Packaging Technologies unit will acquire all of the outstanding common shares (including options) of Liqui-Box Corp. (NASDAQ: LIQB) for cash consideration of $67 per share, which translates into a purchase price of $333 million. Liqui-Box Corp., based in Ohio, is a leading manufacturer of dispensing packaging systems for liquids and other flowable products. Enhance Packaging Technologies, Inc., based in Ontario, Canada, is a supplier of cost-effective and environmentally friendly turnkey pouch technology solutions for pumpable food and liquid packaging.

The new entity, Liqui-Box, will immediately position DuPont Canada as a leading provider of liquid packaging systems in a $5 billion global market that is experiencing growth of 7%-10% per year. As a result of the acquisition, DuPont Canada expects to (i) realize significant synergies related to products, customers, geographies, and technologies, (ii) increase revenues, (iii) add customers among the hospital, restaurant, and other large-scale food providers, and (iv) expand capabilities, which will deliver greater value to customers and shareholders while accelerating DuPont Canada’s momentum in the liquid packaging industry. This acquisition is key to DuPont Canada’s strategy to continually reinvent and expand the scope of its business in fast-growing markets such as food, safety, security, and polymers.

The purchase price for Liqui-Box, Corp. represents a one-week premium to market price of 33.3%. Based on a purchase price of $333 million and LTM financials, DuPont Canada (Enhance Packaging Technologies) will acquire Liqui-Box Corp. at EBIT and EBITDA multiples of 14.7x and 11.0x, respectively, corresponding to multiples that exceed comparable public companies and comparable transactions multiples. Comparable public companies trade at average multiples of 14.0x EBIT and 8.4x EBITDA, respectively, while comparable transactions yield an average of 9.7x EBIT and 5.5x EBITDA.