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For private equity market, all eyes on First Data

Tue, Sep 4 2007

By Michael Flaherty and Dena Aubin - Analysis

NEW YORK (Reuters) - The future of the U.S. private equity market, at least through the rest of the year, appears to rest in the hands of the investors, bankers and executives handling KKR's $26 billion leveraged buyout of First Data Corp FDC.N.

With Wall Street back from summer breaks and Monday's Labor Day holiday, lenders on the First Data deal are out trying to offload the debt to investors.

Hedge funds and other investment vehicles that used to gobble up the debt stopped buying this summer when a credit crunch was sparked by a subprime mortgage mess.

So the First Data financing process, expected to close later this month, is being closely watched across Wall Street as a litmus test for the more than $300 billion of leveraged buyout (LBO) debt clogging the balance sheets of such banking giants as Citigroup (C.N: Quote, Profile, Research), JPMorgan (JPM.N: Quote, Profile, Research), Goldman Sachs (GS.N: Quote, Profile, Research) and Lehman Brothers LEH.N.

"What I hear is that (First Data lenders) are going to try to place larger chunks of maybe $500 million to a billion with a few select large institutional investors rather than putting it out to broad distribution that would cause a lot of turmoil in market," said Nuveen Investments analyst Manny Labrinos.

The credit derivatives market offered the first telltale sign that underwriters were pitching the loans, analysts said. Credit protection costs, a gage of risk, rose on First Data last week by about $50,000 to $75,000 to about $600,000 a year for five years to protect $10 billion of bonds against default.

The rising credit protection costs indicate that the loans will likely have to be placed at higher rates than originally thought -- probably about 4 percentage points over the London interbank offered rate, up from earlier speculation of about 2.75 to 3 percentage points, Labrinos said.

Though the future of the company's LBO financing is unclear, its importance is widely understood.

A TEST CASE

Kohlberg Kravis Roberts & Co. agreed to buy payment processor First Data in April for $26 billion, not including debt. According to a May filing, financing for the deal involved up to $8 billion in junk bonds, and up to $16 billion in senior secured credit facilities. The equity check, financed in part by the banks, was $7.17 billion.

Bookrunners for the deal are Citigroup, Credit Suisse (CSGN.VX: Quote, Profile, Research), Deutsche Bank, Goldman Sachs, HSBC (HSBA.L: Quote, Profile, Research), Lehman Brothers, Merrill Lynch MER.N and Mizuho (8411.T: Quote, Profile, Research).

Other deals waiting for financing are the $32 billion buyout of Texas utility TXU Corp TXU.N. and the $25 billion purchase of student loan company Sallie Mae (SLM.N: Quote, Profile, Research).

But First Data faces the earliest closing date and involves an aggressive financing structure with lots of debt--a structure characteristic of several other LBOs waiting to be financed.

First Data is also a showdown between the banks and KKR, which has refused to renegotiate terms with banks financing its LBOs.

Private equity firms hate adjusting financing terms because it lowers their return expectations on the investment. But that stance makes it harder for banks to sell the debt.

The showdown and the future of the First Data deal will play out over the next few weeks.

"Can the digestive track of the financial system chug through $300 billion-plus of hung bridges, and get to an equilibrium before then?" asked Jonathan Knee, a senior managing director at Evercore Partners (EVR.N: Quote, Profile, Research), using September to the middle of November as the time window.

"Because if not, you're talking about the New Year," Knee said, in an interview with Reuters on Tuesday. "And I think a lot of people have reconciled themselves to the New Year in terms of getting to an equilibrium."

In the meantime, banks face the prospect of having to offload debt for less than they loaned it. Seling that debt at a discount, say 95 cents on the dollar, would free their balance sheets, but incur losses on the loans.

The second task is keeping their private equity clients busy, even while the lending desks are shut. Bankers say that middle-market deals in the hundreds of millions of dollars are likely to continue, because they involve less borrowing. But they make up a much smaller portion of the $11 billion in fees banks earned from LBO firms so far this year.

Should First Data's financing hit a roadblock, big private equity firms are likely step up the pursuit of minority stakes or small, overseas deals as opposed to the mega-sized, $50 billion plus deals they chased prior to the credit crunch.

"The mood is not panicked ....but there is certainly a lot of concern and trying to size up what the potential losses might be," said

Brett Barragate, a Jones Day attorney who represents banks involved in LBOs. "The big issue to be quite honest is nobody knows because we're right at the beginning of this $300 billion of debt."

(Additional reporting by Jeffrey Goldfarb in London)