FOCUSEUROPE
ALM

JUNK CULTURE

High-yield debt has finally crossed the Atlantic—and a small cadre of U.S. firms are finding riches in the junk markets of Europe.

By Michael D. Goldhaber

A single blade of bison grass floats in the bottle of greenish vodka that sits on Malcolm Ross's office shelf. For Ross, the New York corporate chief at Dickstein Shapiro Morin & Oshinsky, there's nothing like a shot of bison vodka to evoke the mysteries of Poland's Bialowieza Forest—and the wonders of high-yield finance.

In 1998, when global capital markets were booming, a $13 million IPO for the underwriters of a Polish liquor company was too small to interest Ross, who was then at Baker & McKenzie. But Ross took the deal as an exercise to train his associates. After the liquor outfit began to thrive, and its initial issuer counsel moved back to the United States, Ross saw a golden opportunity for the firm he had since joined, Dickstein. In September 2004 Ross flew from New York to Poland to talk junk with the CEO of the company, Central European Distribution Corporation. "When you're in high-yield at Latham & Watkins, the business comes to you," explains Ross. "At other firms you go do lunch in Warsaw."

Last year that meeting bore fruit. Through the magic of high-yield finance, Ross helped CEDC double in size and become Poland's largest vodka company. In the second half of 2005, CEDC acquired premium vodka maker Bols Sp. z.o.o from Rémy Cointreau Group for $328 million, and bought control of Polmos Bialystok S.A. in a privatization auction for $270 million. Bialystok is best known for "Zubrowka," a vodka infused with a rare species of sweet grass favored by a herd of bison (now 300 strong) that roam the primeval Bialowieza Forest. The lawyers toasted the acquisition of Bols at the Rémy Cointreau château in the town of Cognac in August. In October they chased the Bialystok closing in Warsaw with shots of bison vodka mixed with apple juice.

Seeking out deals: Malcolm Ross of Dickstein Shapiro

MATT GREENSLADE

LORDS OF EURO-JUNK

CEDC is in many ways a classic junk bond business. It generates high cash flow—few things are more recession-proof than vodka in Poland—but it lacks the pedigree or credit rating to raise money by other means. It also has a charismatic American CEO named William Carey, a former college golf star, who reputedly has the lowest handicap in Poland.

The script is familiar: Junk bonds empowered a feisty little company to roll up its industry and become a billion-dollar juggernaut. What is new about CEDC is its European address. "The vodka deal," says Ross, "is a sign of maturation in the European high-yield market."

Two decades after Michael Milken made junk a powerful word on Wall Street, high-yield finance has found a following in Europe. After a false start during the tech boom, European high-yield is finally flowing strong, at the rate of roughly $20 billion a year. That's enough market activity to make corporate debt the mainstay of several leading U.S. offices in London—providing about a quarter of the work at Latham and Simpson Thacher & Bartlett, and 40 percent at Cravath, Swaine & Moore. "The European high-yield market has grown dramatically in a short period of time," says Cravath's Gregory Shaw, "and that pool of capital is growing."

But even as junk is capturing more of lawyers' attention and time, other forms of high finance are threatening to swamp it. Europe's roaring buyout funds are increasingly turning to rival methods of raising money, like mezzanine loans and hybrid bonds. The European High Yield Association is taking defensive measures, and Latham's Bryant Edwards, who heads the group, frankly admits, "We're worried." The lawyers who tend Milken's shrine in Europe must adapt, lest junk be consigned to the trash bin of European history.

In Milken's day there was no euro, and there was no base of European capital markets investors. In a clubby, overbanked market, European companies—even the worst credit risks—could reliably get cheap loans from their friendly neighborhood commercial banker, who often owned stock in the company. Family-owned continental businesses saw no need for the bother and embarrassment of the public disclosure required by high-yield markets.

Junk bonds first crossed the Atlantic in the mid-1990s, in an experiment that ended badly. Investment bankers introduced U.S. high-yield funds—which were brimming with capital and desperate for bonds to buy—to a newly deregulated European telecom and cable industry that (falsely) perceived huge capital needs for infrastructure. After the tech bubble burst in 2001, a massive wave of defaults ensued, highlighted by the restructuring of the two largest British cable operators, NTL Incorporated and Telewest Communications plc. And, by contrast to American bankruptcies, where junk investors typically recover 45 cents on the dollar, the average Euro-junk bondholder came away with a brutal 20 cents on the dollar. "In 2002 people were predicting the death of the high-yield market in Europe," recalls Felipe de Vengoechea, who later underwrote the Polish vodka deal for ING Bank N.V.

What went wrong with the first wave of European high-yield? One problem was that Milken's portfolio theory calls for diversification, but the starter market in Europe was shallow and uniform. Cable operators from a few German provinces do not diversity make.

The second problem was that bankers didn't adapt the transplanted product to the unique European environment. U.S. investors didn't fully appreciate that, in the event of a European bankruptcy, debtors lack the power to stave off senior creditors with an automatic stay, as under Chapter 11 of the U.S. bankruptcy code. Nor did the junk bondholders fully appreciate that they would only hold claims against the bond-issuing company. (Junk is typically issued not by the operating company, but by an affiliate that lacks assets.) In Europe, bondholder claims are structurally subordinate to claims by senior creditors against the operating company.

Taken together, these features of the European landscape dealt bondholders an unbearably weak hand in the restructuring talks held on the eve of a company's bankruptcy. Banker G. Chris Andersen of Andersen & Company, LLC, who helped to design the first high-yield bond in history at Drexel Burnham Lambert Incorporate in 1976, complains that the professionals who brought junk to Europe lacked "sufficient analytic and credit skills to do it." If they had the analytics down, says Andersen, "they would have realized the need for more diversification and better protection for bondholders."

"The vodka deal," says Ross, "is a sign of maturation in the European high-yield market."

On December 13, 2002, a coalition of ten London institutional investors, including ING Investment Management LLC and AXA Investment Managers Inc., wrote a sternly worded letter to the major global investment banks, warning that European high-yield had reached a "critical point in its development." The investors demanded that junk bonds be redesigned for the European market—so that the operating company would guarantee the payments that the issuing company promised to the bondholders. Only then would the bondholders feel protected in the event of bankruptcy. The bankers agreed, the investors invested, and European high-yield was reborn.

The return of European junk has coincided with a tough few years for U.S. capital markets lawyers in London. Registered offerings by European companies on American stock exchanges have virtually disappeared since passage of the Sarbanes-Oxley Act. PricewaterhouseCoopers reports a total of nine European IPOs in New York since the beginning of 2003. To a significant degree, junk has filled the gap. New issues of high-yield bonds by European companies climbed from an eight-year low of about $5 billion in 2002 to a high of more than $20 billion in 2004, according to Credit Suisse First Boston, LLC, high-yield research.

Lawyers are optimistic that European high-yield will continue to help pick up the slack. The biggest reason is that buyouts are traditionally financed by junk, and European buyouts are booming. Europe saw a record $150 billion in private equity deals in 2005, and overflowing war chests promise bigger deals to come. The British private equity house Permira Advisers Limited is creating the first $12 billion buyout fund in Europe. In January a consortium including Permira paid $15.6 billion for the Danish telecom firm TDC A/S, and for the moment claimed the title of "largest buyout since RJR Nabisco." Rumors regularly swirl of deals that will finally eclipse the $25 billion deal immortalized in *Barbarians at the Gate*.

Two other important trends are removing barriers to the rise of Euro-junk. First, continental commercial banks are becoming disciplined lenders under pressure from the international bank regulator, the Basel Committee on Banking Supervision. If a company that is a bad credit risk can no longer get a loan, it may be forced to issue bonds. Second, an indigenous investor class has come into being. For the first high-yield bonds issued by European companies, the buyers were virtually all American. Today, 80–90 percent of Euro-junk bonds are bought by Europeans, and denominated in euros.

Given the historical trends, London law offices are desperate to get a piece of the high-yield market. Twenty law firms have signed on as members of the European High Yield Association. Only a few firms can truly claim to be the lords of Euro-junk. Four of the firms that dominate U.S. high-yield—Latham, Simpson Thacher, Cravath, and Shearman & Sterling—have parlayed their standing into market-leading positions in London. Still, so many firms are eager to be perceived as junk firms that the association was forced to create alternates on its executive committee. The experience of Dickstein's Malcolm Ross, who is based in New York, shows that the Euro-junk trend is deep enough that aggressive outsiders can reap the benefit. Still, Ross is not a member of the club.

Latham, which is emphatically a club member, boasts of 33 London high-yield deals in 2005, well spread among issuers and underwriters. Although Thomson financial statistics for 2005 do not place Latham at the top [see "The Junkyard Who's Who," page 31], the firm fairly complains that Thomson gave other firms credit for U.S. deals with only a tangential European component.

Latham signaled a serious commitment to the London market in September 2000, when it imported from Los Angeles senior partner Bryant Edwards, who cut his teeth working for Drexel back in 1982. "Bryant's done a very impressive job of turning the market upside down," says one competitor. Since the flow of junk deals resumed in 2003, Latham has stolen seven senior associates from its closest London rivals in the niche, including two from Cravath and one from Simpson. Last year the high-yield group billed some $30 million, or a quarter of London office revenues. Now president of the European High Yield Association, Latham's Edwards has become the high priest of Euro-junk.

Like Latham, Simpson is perennially near the top of junk bond league tables for both issuers and underwriters in London. Partner Walter Looney has quadrupled the head count at Simpson's London office since he took the reins in 1997, and his own specialty of high-yield has been a key driver of growth. Subordinated debt keeps a quarter of the office's 48 lawyers busy. Simpson broke with its own tradition against hiring laterals when it brought in three outside partners over the past three-and-a-half years, two from Allen & Overy and one from Ashurst. A crucial benefit of acquiring English law expertise is that Simpson can offer private equity houses their preferred form of junior debt—whether it be governed by U.S. law or U.K. law.

The two American law firms that round out the shortlist of London's high-yield market leaders are Cravath and Shearman & Sterling. Both work mostly for banks, with Shearman most often appearing for Citigroup, Inc., Cravath for J. P. Morgan Chase & Co. and Credit Suisse First Boston. As at many U.S. offices in London, high-yield has picked up the slack for other capital markets work. Shearman's five capital market partners worked on 11 high-yield deals in 2005. At Cravath's 20-lawyer London office, high-yield accounted for an impressive 40 percent of business last year.

Many British firms have tried to crack the American high-yield citadel with little success. But Clifford Chance and Freshfields Bruckhaus Deringer have made significant inroads. Both of these Magic Circle firms have built a reputation for high-yield work on behalf of issuers. Clifford Chance has turned to its deep stable of private equity clients, including Permira and Apax Partners, Inc. Freshfields has relied on its sterling name in the German corporate world, representing issuers like TUI AG and Fresenius AG.

Last September each firm took an active step to extend its reputation. Clifford Chance recruited Michael Dakin to spearhead a bank-side junk initiative. Dakin left a New York senior associate's position at Cahill Gordon & Reindel, famed for its high-yield practice, to become a Clifford Chance partner in London. "We're trying to create a one-stop shop on the U.S. model," says Dakin.

At roughly the same time, Freshfields asked its two most senior and experienced U.S. capital markets partners, London-based Sarah Murphy and Don Guiney, to devote most of their time to junk. "If you think of high-yield as a niche practice, then you need niche lawyers," says Guiney. "People hire us because we're all over the balance sheet."

Even as law firms beef up their high-yield capacities, they are watching the growing popularity of mezzanine debt nervously. Mezzanine loans are an alternative form of junior debt that originated in the world of commercial banking. But modern "mezz" loans have evolved to resemble junk bonds: They are often transferable, don't pay interest, and have no equity component.

From the viewpoint of a private equity fund, which is looking to be able to exit in two or three years, the big advantage of taking out a mezzanine loan is that it can be repaid at any time. By contrast, the typical high-yield bond can't be called for four or five years. Making an early exit easy has given mezz an irresistible advantage for buyout funds. And therein lies the answer to a riddle. If European buyouts enjoyed a record year in 2005—and junk bonds have historically financed buyouts—why did the market for Euro-junk dip from 2004 to 2005? The answer is mezz.

The only question is, how much mezz financing is available? The high-yield market is so large, when one counts the American funds on the buyer's side, that it can handle virtually any transaction. Traditionally, the European market for mezz debt has been more limited. But hedge funds with a taste for high-yield debt are now buying mezzanine debt in force. Two years ago, the mezz market could only finance transactions of $250 million. Now it can handle deals as large as $1 billion.

Conventional wisdom holds that, in the future, high-yield will finance only the very largest, *Barbarian*-class buyouts, which lie beyond the capacity of the mezzanine market. The mission of the European High Yield Association is to prove conventional wisdom wrong.

Mezzanine debt is governed by local law rather than U.S. law, and that gives an advantage to law firms with strong local capability. Simpson's Looney says that one of the biggest benefits of his firm's new U.K. law capacity is the ability to do whatever junior debt his client prefers. Although Latham is among the few U.S. law firms equipped to handle mezzanine transactions in much of Europe, the legal work is straightforward, and on the underwriter side, it goes to the senior bank counsel, usually a Magic Circle firm.

"The mezz trend," concludes Edwards, "is a net loss for the legal profession."

Naturally, high-yield lawyers emphasize the downside of mezz debt. Its biggest disadvantage for the debtor is that, unlike junk debt, it gives the creditor security and maintenance covenants—for instance, requiring the issuer to maintain a certain ratio of debt to equity. If a company runs into trouble, the mezzanine debt holder can declare a default because maintenance covenants have been violated—forcing the lead bank to foreclose on the security and sell the company. These rights will give the mezz creditors more control over the slicing of the restructuring pie. And when a company is distressed, those creditors often sell their stakes to the litigious investors known as vulture funds.

"Let's wait and see how debtors like vultures armed with mezzanine loans," says Clifford Chance's John Connolly. "God bless 'em," says Edwards, of issuers who preferred mezz to junk. "They may have a different view when a deal goes bad and they're staring across the table at a U.S. hedge fund holding maintenance covenants and security."

But until the credit cycle turns and debtors get burned, private equity issuers will likely continue to prefer mezzanine debt to fund small buyouts. "We're concerned," says Edwards.

To meet the competitive challenge, the European High Yield Association is trying to adapt their product. Most crucially, it hopes to develop a more flexible model—allowing issuers to call the bonds without steep penalties.

An innovative step is the junk bond recently issued by the Spanish cable operator Grupo Corporativo ONO, SA, in a deal lawyered by Cravath and Clifford Chance. In response to the needs of the buyout firms for a quick exit, the Ono bonds' "call period" was reduced to a mere three years. That will allow the issuer to redeem the bonds after only three years if it so chooses.

More generally, the High Yield Association is mounting an ambitious long-term project to lobby the European Union and European governments to improve the standing of junior creditors, like junk bondholders, relative to the senior bank creditors in restructurings.

"Insolvency laws that favor senior creditors are the other big thing holding back European high-yield," says Bryant. "No one's in a better position to see it than a trade association of subordinated creditors."

If mezzanine loans are the major current threat to high-yield, hybrid bonds are the threat of the future. One of the hottest topics among lawyers in the City of London, the hybrid has been called the "holy grail" of the capital markets. A subordinated debt that never comes due, it's treated as debt by tax authorities—but as equity by accountants and credit rating agencies. It can be a substitute for equity that doesn't dilute shareholder capital. Or it can be a substitute for debt that doesn't trash the issuer's credit rating.

Financial institutions have issued hybrid bonds for decades. But continental commercial banks are cutting back on easy loans to poor credit risks. And in early 2005, Moody's Investment Service clarified its willingness to treat hybrids as equity for credit rating purposes. The combination of these two developments has jump-started the issuance of hybrid securities by companies.

Because hybrid finance grows out of the world of bank capital regulation, the advantage goes to the Magic Circle firms that dominate this legal niche in Europe. Freshfields and Allen & Overy have each lawyered four of these new and rare corporate hybrid deals.

Although most of the new corporate hybrids have been issued by investment-grade companies, the concept also appeals to companies that are on the borderline between investment-grade and non–investment grade, or don't want to be downgraded from respectable junk to nuclear waste. Last year Europe saw at least two junk hybrids. In 2005 the French retailer Casino Guichard-Perrachon S.A. issued €600 million in hybrid bonds, and the German conglomerate TUI bought CP Ships Limited of Canada with the help of a €300 million hybrid issue. In a third example, the Italian gaming services firm Lottomatica S.p.A. is partially funding its acquisition of America's GTECH Holdings Corporation with a €750 million hybrid. "I think [the hybrid] represents a threat to the high-yield market," says Christoph Gleske of Freshfields in Frankfurt, who helped to engineer the pioneering junk hybrid for TUI.

London law offices are so desperate to be seen as junk players that the European High Yield Association had to add positions for alternates on its executive committee.

Edwards, of the High Yield Association, isn't so sure. He predicts that institutional high-yield investors will be troubled by the deep subordination of hybrid instruments, and the lack of rights and remedies they provide for bondholders. Andrew Wilkinson of Cadwalader, Wickersham & Taft, who is London's leading lawyer for bondholders in restructuring, also worries that the risks are ill-understood. "Hybrid securities will likely cause more tears as the credit cycle turns," he says.

Stephen Miller of Allen & Overy, who has helped to issue corporate hybrids in France, Sweden, Germany, and Hungary, regards their potential as exciting but finite. "I see it as a growing trend," he says, "but I don't think it'll take over the debt market."

Despite the challenges from mezz and hybrid finance, Euro–junk bond deals are flowing at a healthy clip. The ultimate proof of the junk market's comeback is the return of NTL and Telewest, the two British cable companies whose restructurings were the high-profile symbols of the first wave's unhappy ending. In a deal lawyered by Simpson and Fried, Frank, Harris, Shriver & Jacobson, NTL is issuing more than $3 billion in junk bonds to acquire Telewest, completing the junk-financed roll-up of British cable.

Perhaps, somewhere in Poland, another charismatic entrepreneur is planning to roll up his industry. Or perhaps a British Henry Kravis will emerge to shatter the RJR buyout record. Come what may, the empire builders of Europe still need high-yield finance. The usual suspects, like Latham and Simpson, will wait for the deal to fall onto their laps. The Magic Circle types will polish their PowerPoint presentations. But don't count out Malcolm Ross of Dickstein Shapiro. Ross has a bottle of bison grass vodka waiting on his office shelf for just such an occasion. He's ready to hop on a plane to Warsaw or London, and compete for the next closing with the lords of Euro-junk.