

Dividends Without Tears

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It's that time of year again. We're not referring to barbecues and Slip 'N Slides, although both hot and liquid could be used to describe conditions in leveraged lending today. No, we mean it's time to sit back and watch as dividend recaps come alive again.

S&P Capital IQ's Steve Miller had a great note last week on 2Q dividend activity and expectations for the current quarter. As our [Chart of the Week](#) highlights, dividends to private equity sponsors are on the rise over the past three quarters, thanks in part to the frothy market conditions issuers have enjoyed for months.

Recap volume picks up during times when more "productive" deals, such as new buyout transactions, are absent. That's the case with equally opportunistic loan refinancings and repricings. As Miller points out, though, the current wave of dividends may not enjoy the same head of steam as have prior trends. For one thing, bank regulation has created a more subdued environment for lenders, particularly regarding topsey leverage.

Another damper has been that many recap issuers took advantage of past market conditions so have already sent cash back to investors. Not to say a reprise recap won't get done in this climate marked by a paper shortage. Still, dividend deals aren't always warmly welcomed by loan or bond buyers.

Why the allergic reaction to recapitalizations? In part because taking cash out of portfolio investments reduces a sponsor's "skin in the game," thus diminishing incentive to inject dollars to fix future problems. It also burdens the company with incremental debt without the benefit of corresponding cash flow from capex, or add-on acquisitions.

Of course, returning LP capital is a central fiduciary obligation of GPs, whether in the form of distributions, or an outright sale. Fund performance is also not measured solely by dividends to shareholders. Nice to take the original investment off the table, but would hardly make investors happy with no subsequent return from an exit. Nor are sponsor reputations helped by abandoning borrowers in distressed situations.

Studies have shown that dividend deals offer no more investor risk than other-purposed loans. What really drives higher defaults is higher leverage. Nevertheless lenders consistently approach dividends with trepidation.

To remedy buyer angst, we pose three questions for evaluating prospective recaps:

1. Has the company met its projections since the original buyout?
2. Is the recap leverage equal to or less than the original buyout?
3. Has the sponsor left some of its original investment in the company?

If all the answers are Yes lenders should be favorably disposed towards the transaction. Then consider how deal terms, particularly pricing and covenants, should change compared to the original buyout. No's, particularly to the first two questions, suggest more of an uphill battle.

Finally, particularly for new lenders to the deal, a question to reflect on: how should we feel about putting our money in just as the sponsor is taking their cash investment out?