

FINANCE SECTOR

Central banks raise alarm over leveraged buyout risks

By Gillian Tett in London, Ralph Atkins in Frankfurt and Richard Beales in New York

European central bankers amplified appeals yesterday for investors to be more prudent in pricing and measuring risk, particularly in the region's leveraged finance sector, where activity has exploded this year amid cheap borrowing conditions.

In London, Sir John Gieve, deputy governor of the Bank of England, urged investors to remember that "financial markets are liable to overshoot". He added: "It is particularly important to stay alive to this risk when new records are being set for leveraged bids, returns on equity and City bonuses."

Investors also needed to realise the recent wave of leveraged buyouts, mostly by private equity groups, could lead to a future wave of defaults, he added.

Five months ago, the bank estimated that LBOs were raising the probability of corporate default by 20 basis points, above the long-term average of 2 per cent. However, LBO activity has been so frenetic since then that the bank has raised this additional risk estimate to 40bp, Mr Gieve said.

The European Central Bank warned that increased

leverage multiples and the easing of loan conditions were a "cause for concern".

Leveraged loan issuance has exceeded levels seen in the late-1990s telecoms boom, the ECB said, noting that similarly lax credit conditions and unsustainable leverage levels in the US had "led to corporate failures and produced adverse effects on economic activity".

The comments echo warnings by a host of other regulators and analysts. Earlier this week, for example, Standard & Poor's said there was "extreme credit risk" in the leveraged finance world because of rising debt levels.

S&P also noted there was little sign the easy credit conditions were about to change. The cost of protecting against default on a risky European corporate bond via derivatives fell yesterday to record lows, implying that investors are now more relaxed than ever.

Some observers say the easy credit conditions have been fuelled by a structural change in Europe's asset management world, in which numerous funds have been established that trade portfolios of leveraged loans, creating a new pool of demand for risky debt.

But the conditions also reflect the benign economic

outlook, say many analysts. "Corporate fundamentals remain in good shape," Robert McAdie, global head of credit strategy at Barclays Capital, told global investors. Aside from strong corporate earnings and low interest rates, he said Asian growth was set to continue fuelling the commodities boom, creating more market liquidity and borrowing.

ECB data show that eurozone lending to businesses has recently risen rapidly, almost certainly due to leveraged buyout activity. That is one reason why the Frankfurt-based central bank raised its main interest rate to 3.5 per cent last week – and signalled that further rises were likely in 2007.

The value of leveraged buyout deals reached almost €80bn (£53.5bn) in the year to the third quarter of 2006. Among the biggest recent deals were the €7.6bn battle by private equity firms for VNU, the Dutch publisher, and Kohlberg Kravis Roberts' €3.3bn deal to take a 54 per cent stake in Pages-Jaunes, France Telecom's directories business. Yesterday a controlling stake in ProSiebenSat1, the German broadcaster, was acquired by KKR and Permira, a private equity group.

