eureka report

BYO risk analysis on MYOB’s issue

Philip Bayley10 December 2012

PORTFOLIO POINT: Read the fine print. The MYOB subordinated notes issue prospectus shows there is a minimal margin for error in the financial covenants governing the transaction.

MYOB completed the bookbuild for its subordinated debt issue last Monday. The bookbuild generated commitments of $150 million and set the credit spread to be paid over the 90-day bank bill rate at 670 basis points. Moreover, for the first year, a fixed coupon of 10% will be paid.

With the interest rates available to retail investors steadily falling as the Reserve Bank continues to cut the official cash rate, the MYOB subordinated notes appear to be irresistible. Even if the official cash rate is near zero this time next year, investors will earn almost 7% per annum from the credit spread on the subordinated notes alone.

If this sounds too good to be true, it quite possibly is. As I noted in my last column, the MYOB issue carries a fair degree of risk. Potential investors should consider that this is the largest credit spread to be offered on any retail debt issue so far this year, if not ever, in Australia.
So what is the catch? The devil is in the detail as they say, or in this case in the prospectus.

The key to understanding the credit risks associated with this subordinated debt issue is not so much understanding the business of MYOB, which appears sound, but understanding that subordinated debt is being sought for a private equity deal. It is the structure of all facets of the deal that must be understood.

To do this, sections four and five of the prospectus have to be read.

The private equity investors want to take some money off the table. From the $150 million raised, $90.2 million will go to the private equity investors and $53.8 million will go to MYOB’s bankers.

Allowing equity investors to remove some of their money from a highly leveraged transaction is never a good idea. In this case though, the bankers that lent $530 million to fund the acquisition don’t mind because they are going to get some money back too, and a new group of investors (mums and dads) are going to come into the transaction and provide extra loss-absorption capacity should anything go wrong.

The bankers have structured the terms and conditions of their loan very tightly. There are four financial covenants that MYOB must adhere to. Breaching any of these will trigger an event of default.

In an event of default, the bankers can take control of the business and seek to recover the money they lent. This typically results in the shareholders losing their investment and subordinated debt holders can lose theirs too.

Remember the Nine Network transaction.

The financial covenants are a cash flow coverage ratio, senior leverage ratio and an interest coverage ratio.

From the pro-forma accounts, the cash flow coverage ratio, which simply defined, is MYOB's net operating cash flow divided by its principal and interest debt service obligations, stood at 1.47 times at the end of September this year. Coupon payments on the subordinated notes will be suspended (possibly until the notes mature) if this ratio falls to 1.10 times.

For coupon suspension to be triggered, earnings before interest, tax, depreciation and amortisation would have to fall 21% -- not an impossible event. The good news is that if coupon payments are suspended the payments will accumulate along with a further 2% of penalty interest.

The bad news is that the ratio only has to fall to 1.05 times to trigger a covenant breach. While a covenant breach is an event of default, it is unlikely on its own to result in the bankers taking control of MYOB.

However, there is not a lot of margin for error in the other financial covenants either. Breaching one or more of the financial covenants may have more serious consequences as such an event is likely to indicate major problems with the business.

This is highlighted as a risk in the prospectus.

Maintaining earnings and cash flow is critical for MYOB to service its debt. In fact, it is the only way that all investors in this business will get their money back: MYOB has virtually no tangible assets.

The prospectus reveals that intangible assets, including goodwill, accounted for 94% of total assets, as at the end of September. What MYOB owns is intellectual property, which for the most part, walks out the door each night. There are no assets to be sold if something goes wrong with MYOB.

Another risk highlighted in the prospectus is MYOB's capacity to meet the amortisation schedule that has been imposed by its bankers.

Over the coming year, MYOB must repay $29 million of its senior debt. Over the following three years it must repay $35.4 million, $44.2 million and $48.6 million.

To meet this year's obligation, MYOB has a pro-forma net cash flow before financing of $30.4 million from fiscal 2012. This will cover its fiscal 2013 repayment obligation by less than 1.05 times.

To maintain this minimal coverage ratio and meet its scheduled debt repayments over the following three years, MYOB's net cash flow before financing must increase by 19% compound per annum.

Last year, MYOB increased its revenue by just 4.1% and EBITDA by 7.5%. Growth in net cash flow before financing over fiscal 2012 is not disclosed, but working backwards through the pro-forma data provided suggests growth would have been around 9%.

Going forward, 19% compound growth per annum seems very ambitious, especially in a slowing economy. Failing to make debt repayments as scheduled is another event of default.

Read more at EurekaReport: http://www.eurekareport.com.au/article/2012/12/10/investment-bonds/byo-risk-analysis-myob%E2%80%99s-issue#ixzz2EhJEwHyB