NASHVILLE NOTES

Duration is a Favorable Attribute for Leveraged Corporate Borrowers

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With the conclusion of a relatively inconsequential earnings season for financial institutions, I do not think investors learned anything they did not already know. Yes, estimates trended down modestly because analysts undershot the increase in cost of funds, but that speaks to change at the margin. And, the cost of funds "issue" is likely to peak for most banks in the first half of 2023, unless the Federal Reserve hikes rates further than the current consensus, or loan growth does not slow.

The big issue remains: when will the credit shoe drop, and how hard will it drop?

No one knows for sure. Even the bond market is giving mixed signals. The deeply inverted yield curve often is a reliable precursor to a recession, especially if it persists for longer period.

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On the other hand, yields on leverage loans, high-yield bonds and some collateralized loan obligations have narrowed relative to Treasury yields since last fall. As for the consumer, credit card companies offered troubling trends in loans and leases past due and the like, and upped provision expenses, yet employment levels are high.

No doubt more issues will start to emerge as 2023 progresses, but I offer one vignette about why this cycle may differ somewhat from past ones for some leveraged companies.

The last fourth quarter I worked on a solvency opinion for a private equity-backed industrial company that was in the process of selling a significant asset and in turn would use the proceeds to pay a sizable dividend to equity holders and pay down debt.

A solvency opinion is like a fairness opinion, but focuses on solvency as defined in laws and interpreted by the courts, especially Delaware courts. The gist of the opinion considers four questions: Does the enterprise value of the assets exceed the liabilities immediately after the contemplated transaction occurs? Does the conclusion hold when statutory capital is added to liabilities? Can the firm pay or refinance its obligations as they come due? Would the contemplated transaction leave the company with too little capital?

Like fairness opinions, some solvency opinions are easy yes or no calls, some are close calls and many fall between the extremes. If events subsequently go catastrophically wrong, a board of directors will not want to be challenged for conducting a fraudulent conveyance transaction in which assets were distributed to the detriment of creditors, if the company subsequently files bankruptcy.

The subject company had an enterprise value of several billion dollars that was split roughly 50-50 between debt and equity. Debt-to-EBITDA was about 6x, though from the lenders' perspective, less given the addbacks that were allowed in the lending agreement.

The private equity owners, like so many others, did what they were incented to do during the most recent period of ultra-low rates — borrow long term. Debt financing consisted of a lightly drawn revolver, sizable term B leverage loan and senior notes in which maturities were staggered toward the end of the decade. Plus, the leverage loan was swapped fixed for several years. And because term B leverage loans are structured like high-yield bonds given minimal required amortization, debt service consists of interest only for years.

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Not every levered business is well-positioned for a slowing economy, but massive refinance activity the past couple of years may mean there is more resilience among corporate borrowers. That may account for some tightening of high-yield spreads over several months. The same analogy applies to residential mortgages. Absent skyrocketing unemployment, homeowners are well-positioned to keep making payments that are based on exceptionally low interest rates like much of corporate America.

That said, credit remains an unanswered question with plenty of downside risks, especially for commercial real estate debt that has to be refinanced at higher rates. Debt service coverage will be lower absent higher rents, and presumably many borrowers will have to contribute equity because higher cap rates produce lower values, unless it is offset by higher net operating income. Lenders may be forced to waive loan-to-value covenants and roll notes over shorter time periods, if the inclination is to "kick-the-can" for a while.

It remains very early in the unfolding credit cycle. One outcome is that there will be not much downside because the economy will never slow down enough for a downside to develop. That, however, seems an unlikely outcome, given how rapidly and far the Fed has raised short-term policy rates and pushed borrowing rates up for the economy.

The irony is that while many banks have been caught with too much asset duration via outsized and long-dated bond and fixed-rate loan portfolios, duration for leveraged corporations may lessen the probability of credit issues to the extent the debt capital stack includes floating rate leverage loans that have been swapped for fixed and fixed-rate high yield bonds.

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