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JPMorgan and Morgan Stanley’s bridge loan to Verizon may become a permanent loan

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JPMorgan Chase & Co. and Morgan Stanley will kick-off the roadshow this week for permanent financing to replace a $61 billion bridge loan that will finance the cash portion of Verizon Communications Inc.'s $130 billion deal for Vodafone Group's 45% interest in Verizon Wireless. Assuming markets cooperate, the banks will refinance the bridge loan with $49 billion of bonds and $14 billion of term loans prior to expiration of the bridge commitment in September 2014. Verizon expects to close on the deal in the first quarter.

I offer an observation about financings and banks' roles — sometimes things go awry. This especially seems to be true for investment banks that muscled into the lending business 20 years ago to protect their advisory and underwriting roles from commercial banks' expanding capabilities.

In 1988, First Boston made a $500 million bridge loan to a firm that was taking Ohio Mattress private. The loan was to be refinanced with high yield bonds; however, liquidity in the high yield market evaporated once the Justice Department went after Drexel Burnham Lambert and Mike Milken in 1989, leaving First Boston with what seemed like a big loan that had to be financed with excess liquidity and repos.

In 2006, SunTrust Banks Inc. underwrote a $200 million credit to a company that apparently had one primary customer and deteriorating fundamentals. SunTrust's credit committee may have approved the loan in spite of internal doubts given the customer's importance to the capital markets unit and an effort to build the corporate-investment bank. The syndication effort failed when other banks balked at taking any of the credit, leaving SunTrust with the exposure. SunTrust later charged-off much of the credit when the borrower lost its key customer. In the context of the low credit-loss environment of mid-2006, the underwriting decision seemed to be really bad; however, the credit would pale in comparison to what would unfold in the mortgage and CRE portfolios over the next few years.

More recently Blackstone Group LP's $26 billion acquisition of Hilton Hotels Corp. in 2007 with $20 billion of debt and $6 billion of equity was ill-timed. The economy was then peaking, financing markets were starting to tighten and Blackstone paid a 40% premium to Hilton's public equity price. Among lenders who did not sell their exposure was Bear Stearns, which held $4 billion of Hilton debt when Bear was rescued by JPMorgan and the Federal Reserve. Blackstone subsequently restructured the debt last year, and it hired four banks last month to lead an IPO. CEO Stephen Schwarzman has been quoted as saying Hilton's EBITDA was up 17% in the first half of 2013 compared to 2012. The IRR for Blackstone remains to be determined, but the adage "sit tight and be right" often times has validity for quality assets, especially when the Fed has cut rates.

And sometimes banks get bitten financing themselves. New York Community Bancorp Inc. raised $400 million in January 2004 via a common share issue in anticipation of potentially acquiring GreenPoint Financial Corp.. Instead, North Fork Bancorp (now Capital One Financial Corp.) was the successful bidder. New York Community subsequently incurred $157 million of security losses in the second quarter of 2004 when a charge was taken to unload bonds that were bought before rates began to rise in an effort to leverage what became excess capital.

Multiple buyouts and bridge financing happen every week in the U.S. capital markets. The media only writes extensively about the occasional deal that does not work. There is no reason why the Verizon deal should not be successful, especially given the stability of cash flow produced by wireless companies. Verizon will not be particularly levered with debt projected to be about 3.5x Verizon's EBITDA. Nevertheless, JPMorgan, Morgan Stanley and other bridge lenders may short some of their credit exposure via CDS or other means to hedge their exposure at the margin, especially if the ability to issue permanent financing via the corporate bond becomes more difficult.

Verizon's deal is the third-largest M&A transaction of all time, according to Thomson Reuters LPC. Although the transaction is not ground breaking because Verizon is acquiring the minority interest in a business that it controls, it may signal better things to come in corporate M&A. If so, that should be good for banks. A pick-up in advisory and underwriting fees would supplement what has been a great year for levered loan syndications of $695 billion through August versus $335 billion year-to-date last year. About two-thirds of the syndication volume is related to refinancing transactions rather than "new money" deals such as Verizon's deal.

Verizon's $49 billion bond raise will consist of multiple issues with varying maturities, fixed versus floating and currency denominations. The first tranche is a U.S. $20 billion deal, which will top Apple Inc.'s $17 billion deal that was priced earlier this year. It will follow Sprint Corp., which raised $6.5 billion in high yield debt last week; it was the largest high yield offering since 2008. And Sprint had the temerity to raise the money then disclose that additional debt may violate lending covenants "by a significant level" though Sprint apparently has the liquidity to retire the loans whose covenants were violated.

The banks are bringing the Verizon deal to market at an interesting time when Syria and "tapering" are testing markets. If by chance JPMorgan, Morgan Stanley, Bank of America Corp. and Barclays Plc get stuck with the bridge loan, that might not be all bad. According to the Fed's H.8, loans held on bank balance sheets were roughly unchanged as of Aug. 28 compared to June 30. The banking system remains very liquid following five years of torrid deposit growth and weak loan demand, which is contributing to intense pressure on pricing and increasingly lending standards. A bridge loan the size of Verizon's that unexpectedly became a five-year term loan would soak up a little bit of the banks' liquidity at the margin.

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