SNL Blogs

NASHVILLE NOTES

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You gotta have leverage

By Jeff K. Davis

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JPMorgan Chase & Co. Vice Chairman Jimmy Lee — then global investment banking chief of Chemical Bank of New York — appeared on the cover of the February 1997 *Institutional Investor* issue under the tagline, "You Gotta Have Leverage." The article was published shortly following the merger of Lee's Chemical Bank with Chase Manhattan Corp. It would be three years before the merger with J.P. Morgan & Co. would occur and a decade before JPMorgan Chase & Co. did an end around its Glass-Steagall spawn Morgan Stanley in investment banking. Leverage finance and its tenet that a bank — commercial or investment — should be in a position to advise and fund the entirety of a client's capital structure has proven to be much more successful than envisioned years ago.

SNL's Kevin Dobbs and Hina Nawaz had a post on Aug. 16 about West Coast loan growth that was "mixed" in the second quarter following a weak first quarter. The same comment would apply to most banks around the U.S., though there are regional pockets of strength. One area of the lending market that is robust is Lee's old haunt — leveraged finance. Although definitions of what constitutes a levered transaction vary, the Street (and regulators via its March 2013 interagency guidance) deems firms with total debt-to-EBITDA of 4.0x as levered.

Through July, year-to-date leveraged loan issuance totaled $659 billion, compared to $335 billion through July last year, according to Thomson Reuters. It is an increasingly institutionalized loan market (originate and distribute), something Lee probably would have predicted 25 years ago given his role in transforming the lending market for large corporate and later middle-market loans into a capital market function. Institutions accounted for 61% of year-to-date volume, leaving 39% for pro rata lenders.

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High-yield bond issuance is tracking lending volume higher, too, at $194 billion, compared to $160 billion year-to-date last year.

But the market for large dollar credits, whether funded via loans or high-yield bond issues, is a lot like that for smaller credits — refinancing is the dominant theme rather than borrowing for capital expenditures and M&A. Funding for "new money" loans was just 29% of year-to-date issuance, while bond issuances to refinance (i.e. term-out) loans and call higher cost bonds were the primary drivers of high-yield bond issuances.

Nothing breeds the seeds of destruction on Wall Street like years of uninterrupted success. Markets usually do not correct by going sideways. Excesses in one direction are corrected by excesses in the other direction. So is the levered finance market poised to implode as more signs point to loose lending and Treasury rates grind higher? The market certainly feels heavy to me as leveraged investors such as mortgage REITs deal with declining prices, margin calls and an illiquid August market.

I think the market for leveraged lending should be okay for now since the loans are priced off 30-day LIBOR — though a pause is plausible as investors digest the resetting of the Treasury curve. Investors have poured $34 billion into loan funds year-to-date through July, compared to $40 billion for 2010-2012. Investors have been drawn to the institutional loan market because the yields are viewed as acceptable at LIBOR+400bps (+/-) and because the funds should perform (reasonably) well in a rising rate environment given the floater structure (though most have LIBOR floors of 1.0%). There also is something to be said for moving up the capital structure as a credit investor when high-yield bonds are priced to yield 5-6%. The rate component is ironic because the asset class now yields about the same as money markets did in early 2007 before the financial crisis developed.

High-yield issuances may be vulnerable given low absolute yields for junk bonds when overlaid with the sharp move in Treasury rates five years and out. Flows should be a headwind unless prices drop sufficiently. High yield funds incurred $9 billion of outflows through July, compared to inflows of $50 billion in the prior three years.

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Other fundamentals appear okay too for leveraged finance. Standard & Poor's in its second-quarter review of the leveraged lending market noted that average debt multiples have rebounded to 4.4x last-12-months EBITDA from a cycle low of 3.4x in 2009 but remain below the pre-crisis peak of 4.8x. Interest coverage is better too given the low cost of debt. From a historical perspective, pricing appears good at 1.3x the 1997-2007 average at about LIBOR+400bps for levered loans. Of course, the Federal Reserve has successfully engineered 30-day LIBOR to nearly zero (0.22% as of Aug. 20), compared to the 1997-2007 average of 4.09%.

So what is frothy? *The Wall Street Journal* and Bloomberg have recently chronicled the rise of the dividend recap as a sign of froth. In a dividend recap, a company with reasonably stable cash flow will incur debt to fund a dividend to equity investors. This is most commonly associated with private equity in which dividend recaps may be instituted to provide interim cash flow pending an exit via an IPO or sale of the subject company. Assuming cash flows hold, leverage gradually declines over the next couple of years.

But I am not so sure this is a sign of froth either. Loans to fund dividend recaps have doubled compared to last year, but totaled just $35 billion according to Thomson Reuters, or just 5% of leveraged lending volume this year.

Recap-related lending may migrate to smaller firms and firms that are not necessarily backed by private equity. In a low-growth environment when corporate profitability is good, incremental leverage may make sense for a broader swath of corporate America. Equity is expensive and is subject to double taxation (for C-corporations), while interest expense is tax-deductible and has been made even cheaper by the Fed's zero-rate interest policies.

So what will kill the market? A recession will after a period of Street excesses and much higher leverage that will be signaled by a sustained spike in credit spreads as occurred in the late 1990s and 2007. Usually, Fed tightening via hiking short rates (rather than tapering) precipitates the event after years of credit expansion. We are not there yet.

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