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SNL NASHVILLE NOTES

Tuesday, August 15, 2017 6:09 AM CT

BDCs, Tesla Inc. and quacking ducks

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Institutional Investor had a missive on Aug. 7 about analyst John Bock's coverage beat: business development companies, or BDCs. The article was entitled "Be Damned Careful." No kidding — although the admonition applies to a wide range of credit today that offers little yield and seemingly lots of risk. I have had a number of posts about edgy BDC situations over the years, including greenmail paid by Fifth Street Asset Management last year to rid itself of an unhappy investor and a non-lovefest between Prospect Capital Corp. and Bock. The sector runs the gamut from value destroyers to very good lending teams like those that run Main Street Capital Corp., TPG Specialty Lending Inc. and Golub Capital BDC Inc., in my view.

BDCs are an important and growing source of capital for what are usually levered middle-market companies. Loans to these companies entail high single-digit to low double-digit rates, although interest sometimes is paid-in-kind (PIK) through the issuance of more debt to avoid a cash outflow. This cash flow feeds a lot of mouths. Lenders to the BDCs — which employ a moderate amount of leverage — are paid. Underwriters are paid to raise capital. The BDC asset managers, most of who reside in an external management unit, are very well paid. And investors are paid in the form of high current income, although some BDCs have cut dividends in recent years even though the backdrop for corporate credit has been very good.

The II article noted that Bock's confabs have attracted a growing audience and an expanding list of Wall Street CEOs including those of Goldman Sachs Group Inc. and Blackstone Group LP. I do not know if the executives were there to present on behalf of their companies' sponsored BDCs or drum-up business from investors and deal makers. It does not matter, but the thought I have reading the article is a Wall Street adage: *if the ducks are quacking, feed them*.

The ducks are still starving for income in spite of an increase of roughly 100 basis points in short-term rates in the U.S., but not much elsewhere in the developed world. Plus, the U.S. Treasury curve has flattened as long-rates have eased this year and corporate credit spreads have tightened.

Like the II article about BDCs, the upsized bond issue by Tesla Inc. last week points to an investor base that is quacking for income. Wall Street knows how to feed ducks. With the underwriters boosting the issue to $1.8 billion from the planned $1.5 billion offering, demand was sufficiently strong for Tesla's bonds, which are well into junk territory with a B3 rating from Moody's. The 5.30% yield was a little higher than the 5.0% price talk I heard a few days before the issue priced, but what does 30 basis points matter to Tesla? By way of reference the yield on the Bank of America/Merrill Lynch High Yield Index for B-rated companies was 5.80% on August 11. Tesla, which is the equivalent of a cash incinerator, issued junk bonds well below the average for a B-rated credit; however, someone has to be better than average and it might as well as be Tesla.

That said, I get Tesla from an equity investor's perspective. Elon Musk is the 21st-century version of Henry Ford and Isaac Newton rolled into one. Tesla is spending a lot of money to displace the incumbent auto manufacturers and more broadly combustion engines with new generation batteries. One can debate how much the price reflects it, but Tesla equity is an option on big-time success. Tesla's recently issued bonds, on the other hand, are a credit instrument. There is no upside other than getting repaid. Perhaps the company will become meaningfully cash-flow positive and be raised to an investment grade credit at which point the ability to refinance the debt with lower cost debt will be easier. If that is it, the investment thesis for credit investors is flimsy.

The II article and TSLA bond issue are just two data points among many that it is getting late in the credit cycle. I had a post earlier this summer about another data point in the form of hidden leverage in which lenders are relying upon heavily adjusted EBITDA. SNL ran a research piece on Aug. 10 prepared by S&P Global Ratings that noted the corporate cash hoard that is much discussed in the media is concentrated in the top 25 U.S. corporations. Excluding these companies reveals a heavily levered corporate sector. Although should there be any surprise when borrowing costs are so low? Much of corporate America has made a decision to replace expensive equity with debt that entails very low rates that is subsidized in the tax code through deductibility of interest expense.

But maybe this cycle is going to run much longer than I and others envision. The contrarian investor should note the abundance of top-of-the-market articles such as this one. Last year it looked like a tipping point was within sight when the high yield and leverage loan markets tightened dramatically in the fourth quarter of 2015 and first quarter of 2016 when oil prices were falling and the Fed was talking about four rate hikes in 2016. It was not to be. The Fed relented and hiked only once in December. Liquidity (i.e., investors) returned to the market by mid-year. Many stressed borrowers were able to tap the market. Perhaps the market top will not be in the rearview mirror until income investors are too spooked to stop quacking.

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