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Synchrony and walking around money

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The corporate bond market is on another tear this year, apparently headed for its third consecutive record issuance. Year-to-date issuances through Aug. 21 totaled $995 billion according to *The Wall Street Journal*. An article from a week earlier noted that financial services firms had issued $391 billion through August 13, including $3.6 billion issued by Synchrony Financial that was over 4x over-subscribed. This follows the Synchrony Financial IPO that priced on July 30 at the low end of the expected range, though I think the shares represent a good risk-reward proposition for investors.

As part of its phased spin-out as an independent company, Synchrony is replacing funding provided by majority parent company General Electric Capital Corp. with a combination of unsecured senior debt, bank loans and a growing base of deposits within its subsidiary bank. Synchrony also utilizes a sizable amount of securitization funding. (As an aside, I wonder if the Federal Reserve will eventually lean on the company to acquire a retail bank to build core deposit funding; this appears to have been the case with CIT Group Inc.'s planned acquisition of IMB HoldCo LLC and unit OneWest Bank NA.

Synchrony's debt issue consisted of four tranches, as shown in the table, with laddered maturities of three years, five years, seven years and 10 years. The three-year issue entailed a yield-to-maturity of 1.91%; the 10-year YTM was 4.27%. It is hard to know what passes for shockingly low yields these days. I believe it was Jim Grant of *Grant's Interest Rate Observer* who coined the phrase "return-free risk" when describing bonds during the past few years.

Trending lower and tighter - selected debt issued by financial service companies

Industry	Issuer	Gross amount offered, including overallotment ($000)	Trade date	Maturity	Term of security	Coupon (%)	Yield to maturity (%)	Treasury spread (%)
Banking								
	Capital One Financial Corp.	750,000	04/21/14	04/24/24	10.0	3.75	3.76	1.05
	Huntington Bancshares Inc.	400,000	07/30/13	08/02/18	5.0	2.60	2.64	1.25
	KeyCorp	750,000	11/05/13	12/13/18	5.1	2.30	2.31	0.93
	Comerica Inc.	350,000	05/20/14	05/23/19	5.0	2.13	2.13	0.62
Specialty lender								
	Air Lease Corp.	400,000	01/29/13	03/01/20	7.1	4.75	4.75	3.38
	Air Lease Corp.	500,000	03/04/14	04/01/21	7.1	3.88	3.91	1.75
	Ally Financial Inc.	1,500,000	02/09/12	02/15/17	5.0	5.50	5.75	4.89
	Ally Financial Inc.	750,000	09/04/13	09/10/18	5.0	4.75	4.95	3.21
	American Express Credit Corp.	1,500,000	03/21/12	03/24/17	5.0	2.38	2.43	1.30
	American Express Credit Corp.	1,500,000	08/12/14	08/15/19	5.0	2.25	2.26	0.65
	CIT Group Inc.	1,250,000	05/01/12	05/15/17	5.0	5.00	5.00	4.15
	CIT Group Inc.	1,750,000	07/31/12	08/15/17	5.0	4.25	4.25	3.64
	CIT Group Inc.	1,000,000	02/12/14	02/19/19	5.0	3.88	3.88	2.29
	CIT Group Inc.	1,250,000	07/31/12	08/15/22	10.0	5.00	5.00	3.50
	CIT Group Inc.	750,000	07/25/13	08/01/23	10.0	5.00	5.13	2.52
	Synchrony Financial	500,000	08/06/14	08/15/17	3.0	1.88	1.91	1.00
	Synchrony Financial	1,100,000	08/06/14	08/15/19	5.0	3.00	3.05	1.40
	Synchrony Financial	750,000	08/06/14	08/15/21	7.0	3.75	3.78	1.65
	Synchrony Financial	1,250,000	08/06/14	08/15/24	10.0	4.25	4.27	1.80

Data as of Aug. 25, 2014.
Source: SNL Financial

Synchrony received long-term issuer and senior unsecured ratings of BBB- from both Fitch Ratings and Standard & Poor's Ratings Services, which is the lowest investment grade rating. The registration statement for the notes stated that if Moody's were to rate the debt it would be lower than Fitch's and S&P's rating. One rating lower for Moody's would be Ba1, the equivalent to BB+, which is the highest non-investment grade rating an issuer can obtain. Split ratings are not uncommon. Discover Financial Services is rated BBB- by S&P and Ba1 by Moody's.

Regardless of what the rating agencies think, Synchrony's recent debt issue provides insight into how low new issue yields are and how spreads to U.S. Treasuries with comparable maturities have narrowed during the past few years. Debt issued by financial companies has put in a strong performance over the past five years. The Bloomberg US Corporate Bond Index for Financials had a yield-to-maturity of 2.54% compared to 2.88% for Bloomberg's industrial corporate bond index as of Aug. 22. During 2008 and 2009, yields for financial service companies blew-out; now we are on the other side of that market.

So what is going on, besides the Fed keeping short rates near zero?

Obviously, fundamentals are much better. Banks and most financial services companies have built capital, reduced nonperforming assets and improved profitability. For bank holding companies, the Fed is now a formal governor (as opposed to previously an informal one) on actions that bond investors view as negative: large buybacks and dividends. In other industries this discipline seems to be waning given the steady announcements of buybacks, some of which are being funded with debt. That makes sense in spite of the hand-wringing by bond holders and the bad timing many executives exhibit when repurchasing shares near the top of a market. Companies should think hard about operating with more debt and less equity in their capital structures when the cost of debt is so low.

There is another factor to consider that I think is important for financial service companies: parent company liquidity and leverage. Companies with a greater amount of common equity (and noncumulative preferred) in the parent company capital structure require less cash than those with debt (and noncumulative preferred), all else being equal. It is a subtle shift for bank holding companies, but one permutation of tighter regulation is that most mid-size and large bank holding companies operate with some amount of excess liquidity at the parent company. If upstream dividends are interrupted or the parent is called on to be a "source of strength" for the banking subsidiary, the parent company today has greater flexibility than many did pre-crisis. It is what one CEO of a bank that avoided material capital structure challenges in the aftermath of the financial crisis called "walking around money" for the parent company — meaning that it may be idle cash, but it provides flexibility for the parent company.

In addition to the disclosure of a lower potential rating by Moody's, Synchrony disclosed in its registration statement that while not contractually required to do so, it was providing credit enhancement in the form of additional loan receivables collateral to obtain confirmation of current ratings on its asset-backed securities. With the phased separation from GE Capital, Synchrony expects to be named as servicer for existing securitizations and future issues. Synchrony is a lower-rated credit than GE Capital (AA+/A1). The additional collateral is a technical move that investors in the existing ABS deals will like and perhaps demand if they are going to invest in future Synchrony securitizations.

While bond (and ABS) investors have been willing to accept very low yields, I think they historically have been better at detecting turning points in the market than equity investors — perhaps because they are focused on the numbers and not the narrative spun by executives and analysts about why a share price can go higher. It was the nonagency MBS market and other areas of the bond market that began to freeze in the summer of 2007 when the equity market was on its way to then-new highs in October. Two recent SNL posts touched on investors' increasing sensitivity to subprime auto paper. We will only know in hindsight if a turn in subprime auto credit quality has occurred, but investors may begin to tighten credit to the sector by requiring wider spreads for new financings.

For the broader corporate bond market investors are not yet signaling any imminent turn in credit quality — nor are any of the bankers that I speak with. These investors seem to be okay with the fundamentals of corporate credit, even as you and I question how any money can be made when the yields are so low.

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