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Just Over the Horizon

With a possible slowdown in the economy coming, the groundwork could be laid for rapidly mounting credit challenges.

by Michael T. Newsome

Unusual turmoil in the credit markets marked the dog days of this past summer, all leading to rising concern over the availability of corporate credit. The impact has painfully hobbled the high end of the buyout market. An unprecedented pipeline of multi-billion dollar LBOs (think Sallie Mae, TXU, First Data, Harman International, etc.) has been hung up at prominent commercial and investment banks when new issuance in the primary institutional syndicated loan and high yield bond markets ground to a halt. The fallout has been tighter leverage requirements, a spike in pricing, and speculation that a serious credit crunch is in the offing.

Interestingly, impact on middle-market lending has been more modest—slightly tighter leverage and, perhaps, a bump in pricing. Thus far, there is little evidence of the alarm that would precipitate a broad curtailment of credit in the middle-market. Our read on the situation is that the "crisis" is a result of an imbalance of supply and demand, fueled by investor jitters in specific markets. More than anything, it seems to be the classic case of a snake trying to swallow a large pig whole—an achingly slow process with a good deal of indigestion. Already there is evidence that the market is functioning as deals are either pulled or restructured and completed. The real concern is that just over the horizon lies the potential for credit problems to emerge from the large number of highly leveraged loans booked in the go-go environment of the past couple of years.

THE GLUT

The syndicated loan market has two major components. The more familiar is the bank or pro-rata syndication market, where bankers buy and hold loans between $50 million and, perhaps, as much as $2 billion. The institutional market is the newer and much broader segment where large multi-billion dollar financings occur. The loan buyers in this market are institutional investors that include collateralized loan obligations (CLOs), hedge funds, and other fixed-income investors. CLOs hold the lion's share of the volume, although there is considerable overlap with hedge funds,

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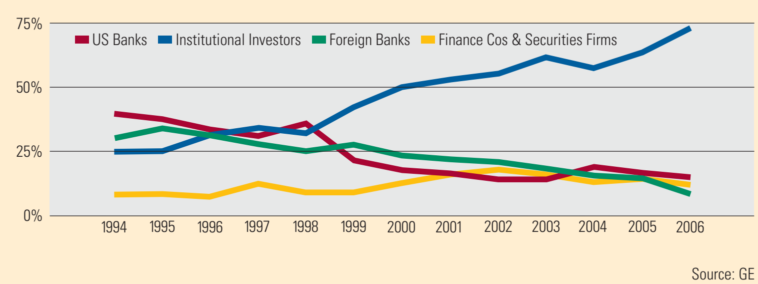
which are major CLO organizers. Banks are minor players. A critical point to understand is that the major CLO funding sources are money market funds that buy the highly rated (A-1/P-1) commercial paper that CLOs issue.

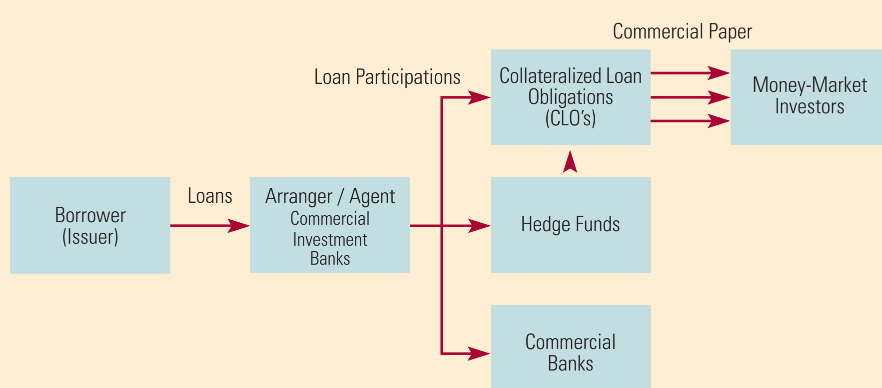
As illustrated in the adjacent chart, borrowers (issuers) rely on large commercial and investment banks, known as dealers/arrangers, to distribute shares of the syndicated debt to a broad array of investors (CLOs, hedge funds and banks). Like the bond market, investors use rating agencies (S&P or Moody's) for credit assessments. Because this distribution process is time consuming and embodies some risk, issuers frequently fund the loan on an interim basis with a short-term bridge facility or warehouse line from the banks that serve as dealers/arrangers. A hefty fee is paid for a "fully underwritten" commitment guarantying that the loan will be distributed on the agreed terms.

Through September, private equity led buyout transactions totaled nearly $750 billion, almost equal to the entirety funded in 2006. When the music stopped, about $237

Share of the Syndicated Loan Market



Institutional Syndicated Loan Market



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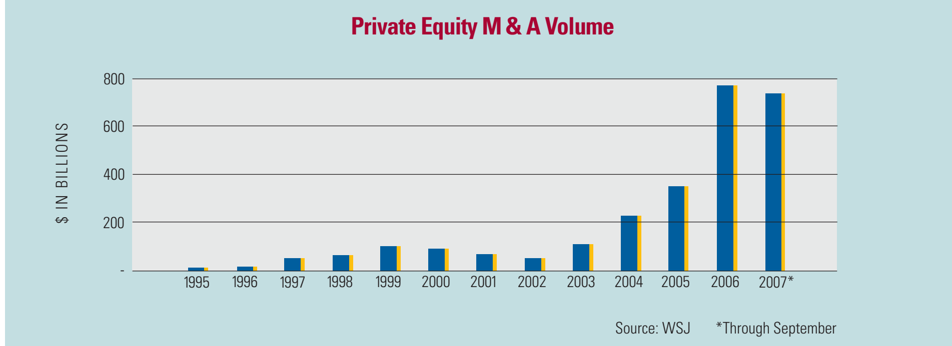
billion of leveraged loans supporting these buyouts were in a massive queue, either having already been funded on a bridge basis or fully underwritten and awaiting distribution to investors.

WHAT WENT WRONG

The "credit crunch of 2007" is comparable to past financial market bubbles. In this case, syndication arrangers observed the willingness of the CLO and hedge fund market to absorb leveraged transactions on increasingly accomodative terms. The mistake was to assume that this young dynamic market was stable and without limits. But, the size of any financial market is affected by the availability of substitutes. As terms got more aggressive, buyers had second thoughts. All the while, the large commercial and investment banks, driven by the perceived opportunity to profit from accessing this new market, underwrote a large volume of loans under terms the market would no longer accept.

The beginning of the rapid change in market conditions began at the source of all funding, the buyers of CLO commercial paper. It was the collapse of the sub-prime market that initially spooked money-market investors, making them cautious about the limited transparency with regard to the type and mix of assets that back the commercial paper issued by CLOs. This triggered a flight from commercial paper to Treasuries. In turn, a number of large banks were forced to step in and fund back-up lines that provide liquidity to CLOs that could not sell their commercial paper. The impact was clearly evident in interest rates—Treasury rates fell sharply, as investors moved away from commerical paper, and LIBOR rates spiked as banks raised the funds, at a premium, to meet CLO liquidity calls.

The upshot of all of this is that financing activity for mega-LBOs in the institutional loan and high-yield bond markets is now essentially a trickle relative to the activity in the prior seven months. The biggest funding sources, CLOs, are essentially shut down and out of the market until the portfolio transparency issue is sorted out. Many deals underwritten on the most aggressive terms remain in limbo, are quietly being withdrawn, or sold at



discounts. The investment and commercial banks that arrange and distribute institutional syndications have put new deals on hold until they work through the backlog sitting on their balance sheets. A rash of earnings warnings are being issued by large investment and commercial banks (Citigroup, Morgan Stanley, and UBS were among the first) as deals are marked-to-market and sold. By the time this is read, many other big banks will have bitten the bullet and reported similar pain.

MIDDLE-MARKET IMPACT

As with most credit market trends, the events in the major markets drift downward to the middle-market and this time is no exception. Credit spreads have drifted upwards, maximum leverage has declined, and covenants have reappeared. With the caution that the full story on the credit crunch is still unfolding, the truth is that the credit appetites of the middle-market lenders active in the Northwest remain quite strong. Discussions with middle-market lenders, including Bank of America, U.S. Bank, Wells Fargo, KeyBank, and the middle-market-oriented regional banks, confirm they are open for business.

The ground lost was in an area that few prudent borrowers would care to occupy. The highly favorable terms and conditions obtained by some borrowers were short lived, as the market has returned to saner levels. In June and July, we observed several middle-market-sized ($100-250 million) leveraged loans being made in excess of 6x EBITDA, with very attractive pricing and limited covenants. Today, the limit has been re-established closer to 4.5x EBITDA, with pricing more than 150 basis points higher (LIBOR +400 bps, compared to 250 bps earlier). In any period other than the past six months, these terms would be considered quite accommodating.

OVER THE HORIZON

Much like the sub-prime market, a very large stock of highly leveraged loans is already in place in the institutional market. The firms shouldering the burden of this debt must either consistently perform at a high level for an extended period or have an attractive arbitrage to the public equity market. These borrowers are vulnerable to event risk, such as the loss of a key customer, an unanticipated competitive development, or general economic decline. With news of weaker consumer spending, a prolonged stall in housing, and increasing commodity prices, one has to wonder whether a slowdown in the economy is in the works. Loan delinquency rates remain at extraordinarily low levels. But, there should be very little doubt that there is plenty of grist in place for deterioration when conditions change. Even a modest downturn will make it more difficult for highly leveraged companies to maintain the cash flow needed to support razor thin debt coverage ratios. Not all companies will make it.

Far from projecting impending economic malaise, what we are saying is that the groundwork has been laid from which credit challenges could rapidly mount. When lenders encounter tougher sledding, all borrowers can suffer the effects of a credit crunch, even those with conservative capitalizations. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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