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INVESTMENT BANKERS

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A New Year Begins

All the early economic signs point to a positive 2014.

by Michael T. Newsome

On the brink of a new year, sounds of optimism fill the air. With the S&P 500 climbing nearly 30%, unemployment falling below 7% (albeit against a backdrop of declining labor participation), and recent news of third quarter GDP growth of 4.1%, expectations for a robust 2014 have been bolstered. About this time each year, most major banks host forums and roll out their economists and investment strategists to reflect on the year past and offer opinions with regard to the prospects for the coming year. We expect to hear that the economy has made modest headway over the past several years, but has been stuck in low gear as businesses and consumers struggle with added taxes, regulation and debt associated with efforts to pull the economy out of the "Great Recession". The engine is powerful, but the burden is heavy. All in all, the conventional wisdom suggests that 2014 will bring a continuation along the same path, but with stronger growth potential on the upside. This is subject to the admonition that it all depends on the actions of the Federal Reserve.

THE FED'S ROLE

We are all Fed-watchers now. As many are aware, it is the Federal Reserve that is actively directing economic moves. Its chief tool since late 2008 has been the monetary policy known as quantitative easing ("QE"). QE entails the purchase of short- and long-term government and mortgage-backed securities, including substantial amounts from banks, by the Fed for its own balance sheet. By stoking demand for debt securities, long interest rates have been held low, short rates have been at or near zero since 2009, and the banking system is loaded with liquidity. The expectation was that substantial amounts of inexpensive credit would fund investment, thereby generating economic growth. Many worried that inflation would be the unintended consequence as new money is "printed" and injected into the economy.

So far, neither the expectations of QE proponents nor QE skeptics has been realized. Borrowers have not responded to the temptation of easy and cheap money; therefore, the recovery from the recession has been slow. Inflation also has not appeared, as the massive liquidity creation has largely not flowed into the economy. Instead, as shown in the nearby chart, much of the proceeds from Fed bond purchases has piled up on bank balance sheets as idle excess-reserve deposits with the Fed. Since banks cannot find a home to lend these funds, they earn a meager 25 basis points per annum lending the funds back to the Fed. Banks would love to put these reserves to work, but have struggled to find qualified borrowers with appetites to deploy additional leverage.

The jury is still out with regard to the efficacy and ultimate effect of QE, but two conclusions are not debatable:

1) Long and short rates have been held in relatively tight ranges, still near 50-year lows, and

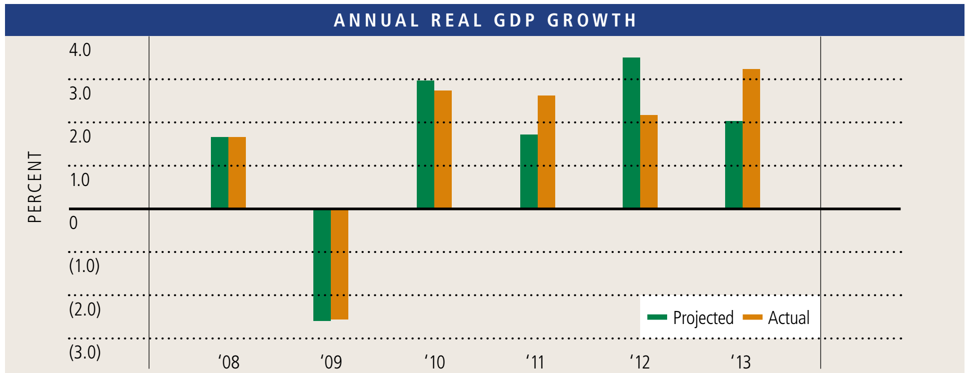
2) Liquidity at banks is at an all-time high and is available to flow into the economy when borrowers decide it has uses for the capital.

Expert interpreters of the Fed say that current policy is locked in and will suppress interest rates through 2016, and that it will gradually ratchet back its QE program to avoid inflation. Execution of that policy remains a nagging longer-term concern, but most feel it is a battle for some day far in the future. Eventually, how excess liquidity is managed will matter. If demand for credit rises and reserves are redirected into the economy, the money supply will grow and inflation worries will return. If the Fed attempts to sop up excess reserves by selling the securities off of its own balance sheet, pressure will ratchet up on interest rates and tighten credit. The Fed is operating on the edge of a knife and deserves close monitoring.

CREDIT MARKETS TODAY

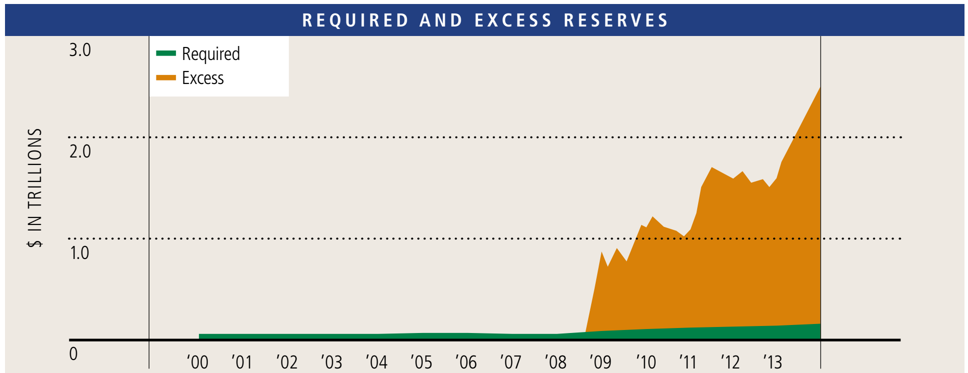
Despite the availability and low cost of credit, demand was modest in 2013, driven primarily by refinancing to improve borrower

ANNUAL REAL GDP GROWTH



Source: Congressional Budget Office

REQUIRED AND EXCESS RESERVES



Source: Federal Reserve

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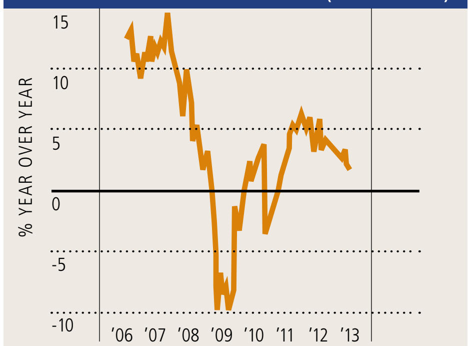
flexibility and/or reduce credit costs. After a sharp rebound in the rate of loan growth following the credit crisis, the overall pace of loan growth has steadily declined for nearly two years. Five years following the financial crisis, credit assets have not yet recovered to the 2008 peak. In spite of heightened regulatory scrutiny and compliance requirements, banks remain quite keen to lend.

Although sometimes masked by the general

TOTAL LOAN GROWTH RATE (US BANKS)

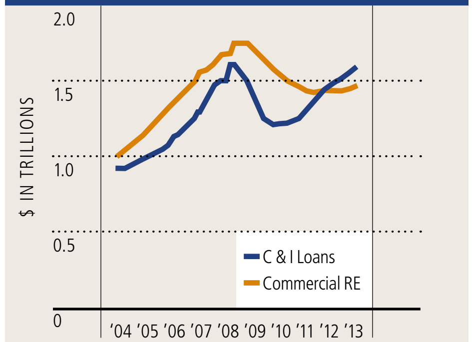


Source: Federal Reserve

level of interest rates, credit risk premiums (aka credit spreads) have also narrowed dramatically over the past several years as excess liquidity has generated greater competition among lenders, driving rates and terms to near-record advantage for creditworthy borrowers. With lenders moving down the price curve and out the risk curve, the cost of credit risk has eroded—down an average of 200 basis points across all risk segments over the past several years. While middle market pricing data is hard to come by, we know this both anecdotally and by observing the steady wearing away of bank net-interest margins quarter by quarter.

The erosion of risk premiums is evident in the high-yield bond market where new issues are being priced in the sub-6% range. The current spread (see adjacent chart) between average high-yield bond and 10-year Treasury bond yields is a mere 355 basis points, as compared

COMMERCIAL CREDIT OUTSTANDING



Source: Federal Reserve

to the average spread since 1999 of 576 basis points. As described in our article ("Middle Market Mezzanine: The Evolving Product")

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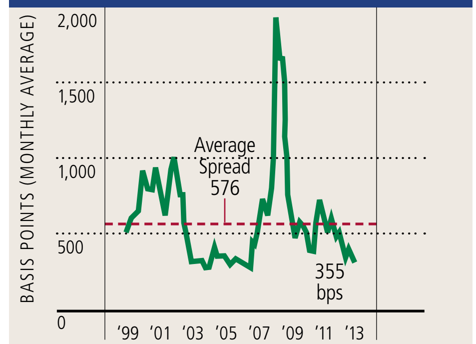
in the 2013 Summer issue of IN$IGHT, mezzanine lenders have accepted dramatically lower pricing for arguably more risk. Even private equity investors have rolled back their expecta-

Many businesses reallocated available cash flow from interest expense to principal reduction, thereby speeding the recovery of business balance sheets.

tions; once targeting 30+% returns, they seem pleased to earn "upper teens" returns in today's competitive environment.

A secondary impact of ultra-low rates has accelerated de-leveraging of business balance sheets. Many businesses reallocated available cash flow from interest expense to principal reduction, thereby speeding the recovery of business balance sheets. In some cases, once-trou-

HIGH YIELD BOND SPREAD OVER 10 YEAR TREASURIES



Source: Federal Reserve

bled firms have earned their way back to health.

LOOKING FORWARD

What should a business owner do in this environment? Of course, it all depends on the specific situation, but if the economy remains stable and improves as the experts suggest…

1. Consider accessing the considerable pools of private capital that are priced at historically low levels. Investments that promise to return real economic value and/or prudent recapitalizations to take excess capital off the table to achieve shareholder wealth diversification can be accomplished with access to capital on historically attractive terms.

2. Hedge against the risk of rising interest rates proactively and incrementally. Layer in risk protection over time or structure forward hedges to take advantage of subsidized low current rates. Consider option products that cap rate exposure rather than lock in a fixed rate. Seek independent advice on hedging options and strategy. **ZS**

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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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