Zachary Scott
TRUSTED ADVISORS

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No Rain, but Clouds are Forming

There are signs that credit could be tightening in the near future.

by Mark Working

"All I know is that sometimes you have to be wary of a miracle too good to be true, All I know is that sometimes the truth is contrary to everything in life you thought you knew"
Rush
Clockwork Angels
2012

Much has been written about how cheap and abundant credit has contributed to the strong valuation environment for privately held businesses. In the fall of last year, we authored an IN$IGHT article on that subject – "Growth, Leverage, and Multiples," which describes our observations on how certain buyers think about how credit fits into their valuation equation. Given the length of this strong market, more recently, clients are asking us "what could happen to end this period of high prices?"

There are many externalities that could affect buyers' appetites to acquire businesses (e.g., war, currency devaluation, higher interest rates, a recession), not all of which are independent of each other. A likely leading indicator is a contraction in credit availability. Based on current credit appetites supporting leveraged acquisitions, there is no observable evidence that credit is tightening. Nevertheless, we are observing some precursors to tightening credit that might begin to impact valuations of businesses in the middle market.

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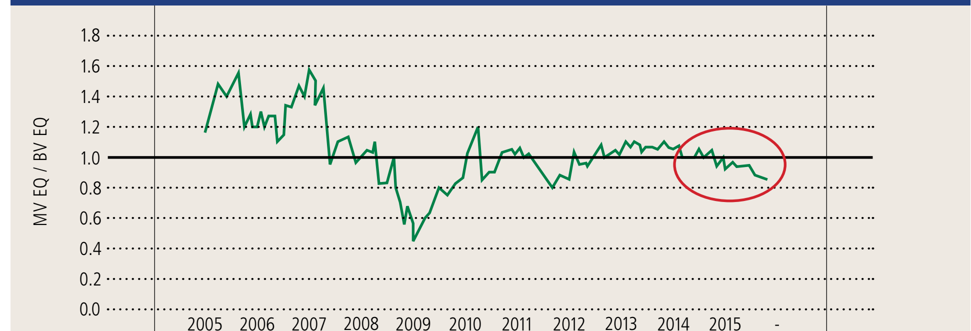
STATE OF LEVERAGED CREDIT

Bank balance sheets are pristine. Delinquent loans are almost non-existent. Non-banks claim the same condition. Losses in mezzanine funds are only in memory from a distant business cycle. Yet, there is some evidence to suggest that cracks in the credit quality of leveraged loan portfolios are forming, which directly leads to tightening credit and higher pricing.

An indicator watched by the corporate bond market is the spread between U.S. Treasuries and High Yield bonds of similar duration. The last time lenders were as aggressive was in the run up to the 2008 crash. At that time, the spread between treasuries and high yield corporate bonds dropped to approximately 3%. As the recession took hold, credit spreads soared as the credit markets virtually shut down for nearly a year. The Fed then aggressively pushed forward its zero interest rate policy (ZIRP), which was designed to encourage borrowing and risk taking so as to stimulate the economy. Except for a blip in 2011 when a second recession was feared, credit spreads fell to a low of approximately 4% in mid-2014. Since that time, credit spreads have marched upward, an indication that investors are demanding additional reward for taking on the risk of leveraged corporate credit.

The private market equivalent to the high yield bond market is the credit issued by Business Development Companies ("BDCs"). BDCs (see IN$IGHT Fall 2014, "Expanding Range of Credit Options") have been the lifeblood of acquisition financing over the past few years as they have provided very high leverage (historically speaking) to fund change of control transactions. This market is also beginning to show signs of strain.

BDCs are prohibited from raising new capital when the market value of their equity trades below the net book value of their loan portfolio. Not unlike other credit sources, BDCs took a hit following the Great Recession, but recovered



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and began booking loan assets with great haste. As illustrated in the nearby chart, in mid-2014, the market value of BDC equity (composite) edged below net book value and has continued that downward slide. This phenomenon suggests that investors are convinced there are unrealized losses in BDC loan portfolios.

Although not yet widely reported, (perhaps outside of the energy industry), the number of criticized loans, those that are not delinquent but that have experienced covenant defaults and/or weaknesses in debt service coverage, is growing. Conversations with credit administrators and portfolio managers suggest that concerns over portfolio quality are emerging.

The Treasury Department recently commented on this state of affairs in its most recent annual Financial Stability Report that warned “higher rates and widening spreads between corporate and Treasury rates may create refinancing risks, expose weaknesses in heavily leveraged entities, and potentially precipitate a broader default cycle”. It went on to say that “even a modest default rate could lead to larger absolute losses than in previous default cycles”.

IMPLICATIONS FOR M&A PRICES

There are few business sale processes in the middle market that do not involve private equity funds as competitors. The aggressive approach taken by many private equity buyers has allowed them to be winners in the auction sweepstakes, sometimes even when competing with strategic buyers. At the very least, they push the price bar higher.

Sellers have been rewarded in deals where private equity funds have probably paid too high of a price as a result of the availability of low cost leverage. In a constrained credit market, the pendulum can swing the other direction when private equity firms lower prices in order to preserve returns on their equity.

IMPLICATIONS FOR A DEFAULT SITUATION

This time could be different. In past down-credit cycles, lenders transferred companies straining to meet their obligations to a special department where seasoned professionals worked with borrowers to manage credit exposure, using appropriate amounts of discipline and patience, often to the benefit of both borrower and lender.

Healthy credit portfolios combined with lenders’ desire to maximize margins in this highly competitive, higher capital environment have caused many lenders to downsize or entirely eliminate their workout departments. While this has certainly reduced expenses, it also means that in the next down-cycle there will be fewer experienced workout professionals and therefore less predictable behavior among lenders.

AND THIS MEANS?

It is too early to predict demise of the credit markets, but there are some clouds forming on the horizon that, if they continue, could change lender appetites. Any contraction in the availability of leveraged acquisition credit will likely have some dampening effect on valuations of middle market privately held companies.

A simultaneous effect for companies experiencing difficulty with their capital structures will be a more challenging and stressful process for getting through troubles.

Taking advantage of the current seller-friendly markets to take some chips off the table and/or shore up a balance sheet could be a timely action. **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, go to **ZacharyScott.com.**

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