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INVESTMENT BANKERS

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Time To Leverage the Balance Sheet?

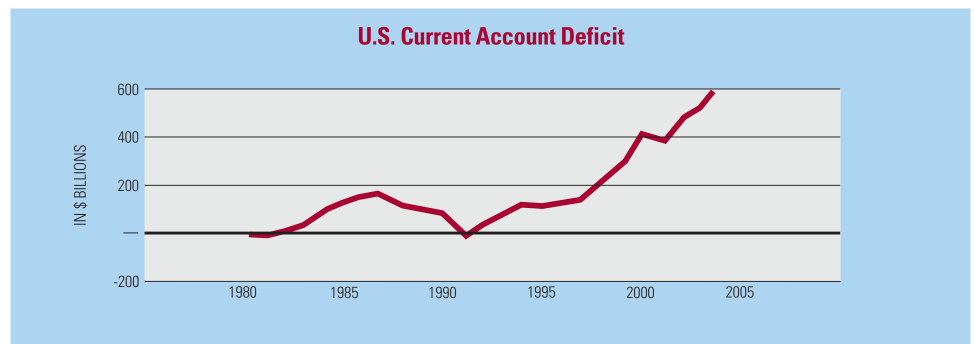
Lenders are ready and willing to make loans, but businesses remain wary; for some this could be a mistake.

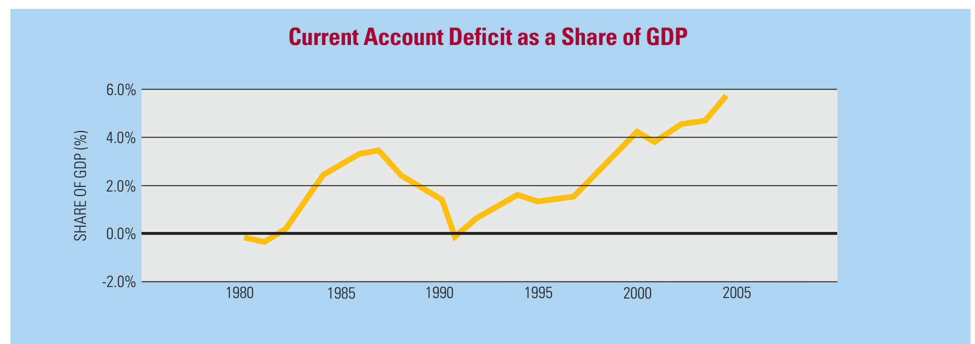
by Mark D. Working

As we have repeatedly reported in *INSIGHT* for more than a year, lenders are falling all over themselves to make loans. But, to their dismay, corporate America has not been taking them up on the proposition. Hesitancy may be a mistake for certain companies, as the window will not stay open indefinitely. There are points in every business cycle where it is possible to minimize a company's cost of capital, and we think that time is now.

WHY AREN'T BORROWERS BORROWING?

The slow recovery of the economy from its bubble-bursting internet/telecommunications recession and the aftermath of 9/11 has kept corporate managers wary. The fact is that manufacturing capacity is still under-utilized in many sectors. Therefore, the demand for investment in new production assets and the consequent requirement for capital has been less than might otherwise be expected. At the same time, productivity has continued its march forward. Businesses have pared costs and increased efficiencies. The result is that companies have enjoyed strong earnings and are more liquid than ever. Rather than borrow, corporate managers are reducing leverage and building liquidity. Until demand for working capital and fixed-asset investment absorbs the current store of liquidity, external capital won't be required.





IS THERE REASON FOR CONCERN?

With a short supply of borrowers, won't bankers remain hungry until they achieve their goals for asset growth? We're beginning to think otherwise, due to a nettling little issue known as the "current account deficit" and its potential impact on the economy.

The current account (net trade balance plus net investment balance) is currently $600BN dollars in deficit, a level never before seen, whether measured on an absolute basis or relative to U.S. GDP. This shortfall is being funded by foreign entities. To put the situation in context, it is as if your company is at the top of its line of credit from multiple lenders, any or all of which could choose not to advance at any time. The current account deficit continues to grow at the rate of $100BN per year and the U.S. economy is relying on foreign central banks to keep stepping up to higher amounts. An interruption to this pattern could cause problems.

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Alan Greenspan has argued that we should not lose sleep over the size of the deficit. First, the deficit is largely being funded by Japan and China, which have been willing to stomach relative currency depreciation in exchange for the economic growth provided by trade with the U.S. This policy is irrational from an economic standpoint, but appears to serve a political purpose. The conventional wisdom is that everyone has an interest in keeping the game going. Political instability would be risked if the music stops. The second argument is that the United States remains by far and away the best place in the world to invest money. The country is stable, financially healthy, and home to some of the most productive and profitable companies in the world.

As we learned from the internet bubble, economically irrational behavior can continue longer than one would expect, but eventually reality prevails. So, what happens if/when foreigners decline to fill the growing void? The dollar will be driven down against almost all currencies, interest rates will climb, and inflation pressures will grow. The adjustment process may not be smooth and painless. Some businesses will be adversely affected.

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One thing is certain, lenders and investors abhor instability. Regardless of the shortage of loan assets, once business performance becomes less predictable, the needle will begin its swing from "greed" back towards "fear" and credit parameters will tighten. This will affect all borrowers. The consequences are likely to be less lenient term lending, lower advance rates, tighter covenants, and upward pricing pressure.

HOW TO BENEFIT FROM CURRENT CONDITIONS

Of course, we are not recommending that businesses rush to lever up their balance sheets to take on additional financial risk in the face of increasing business risk. What we are suggesting is the following:

1. All businesses should lock up long-term borrowing arrangements that will provide liquidity to the business tomorrow, on today's terms. That could mean expanded borrowing bases, multi-year commitments, and term loans that free up the line of credit as a liquidity reserve.

2. Middle-market business owners with stable franchises should consider taking advantage of the borrower's market to take some chips off the table. When the cycle turns, it will be a few years before today's lending conditions return.

3. Companies with sufficient scale to access the public debt markets, or the equivalent institutional debt market, should consider this alternative, as they will find the risk/reward meter is pointing even more dramatically in the borrower's direction.

We don't know when conditions might change, but it appears that there's nowhere to go for the dollar but down. As it does, interest rates will have to rise. It is prudent to begin planning for changing conditions and, if appropriate, take advantage of today's unique conditions before they pass. ❖

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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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