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INVESTMENT BANKERS

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Facing the Wave of Refinancing

Demand for debt capital by middle-market companies may exceed supply.

by Michael T. Newsome

Although the darkest days of the financial crisis seem to be in the rearview mirror, major challenges lie ahead for middle-market businesses that are reliant on borrowed funds. Despite weak current credit demand, the realities of the global economy strongly suggest that credit markets will tighten further and may remain difficult for the foreseeable future. This simply will be the consequence of demand for debt capital outstripping bank-lending capacity.

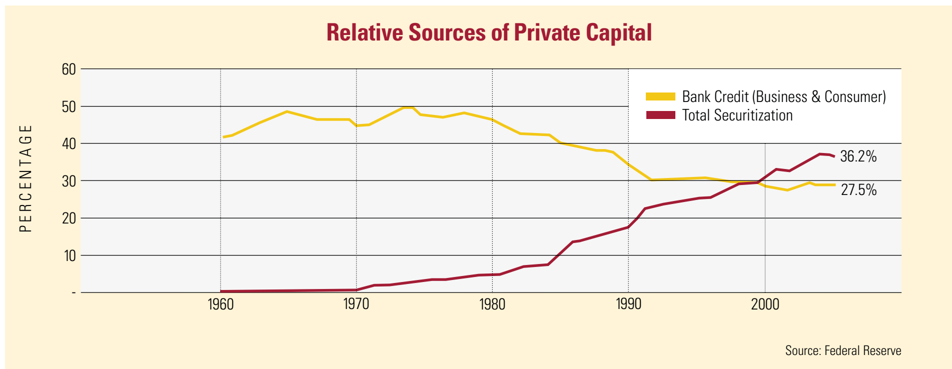
COMPLACENCY

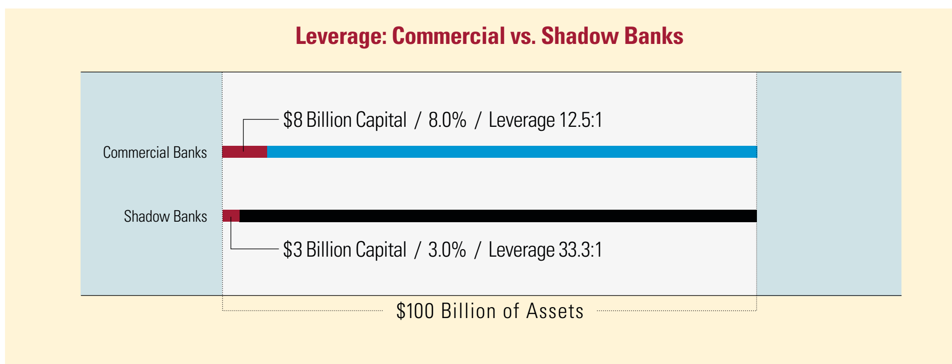
In recent months, we have repeatedly heard CFOs espouse the notion that they have very attractive, "below-market" credit commitments. The conventional wisdom is to avoid, if possible, marking these credit arrangements to market, which may entail a bump in credit spreads, a stiff amendment fee, and, perhaps, a punitive covenant and/or availability adjustment. The effort to maintain the status quo is predicated on the hope that, 12 to 24 months down the road, banks will recoup their former vigor and again be eager to court middle-market business. This may not be the most prudent financing strategy given our expectations for further credit-market tightening.

CREDIT EXPECTATIONS

Traditionally, the chief proficiency of banks has been the origination of loans–assets, in the parlance of bankers–to businesses and consumers. In the period from 2003 to 2008, bankers were able to generate far more assets than they were inclined to hold for their own books. This excess was funneled into the "shadow banking system," which is principally comprised of securitizations. As discussed in prior IN$IGHT issues, securitization is the process of pooling financial assets to serve as the basis for issuing highly rated and, at the time, seemingly attractively priced, asset-backed securities (ABS) to institutional investors. This lucrative practice worked well, but led to gross abuse when volumes were ratcheted up in pursuit of fat origination/arrangement fees.

Nearly $6.0 trillion of ABS[1] were issued in the U.S. between 2004 and 2008. This accounted for more than half of all new consumer debt and sizeable shares of permanent commercial real estate loans, vehicle and equipment financing, and the leveraged lending that underpinned private-equity investment activity.





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As illustrated in the above chart, even today, securitizations comprise a larger share of outstanding private credit than banks do.

A principal impetus for the shift of credit away from banks to ABS was a drive to use capital more efficiently. As illustrated in the above chart, a "well-capitalized" bank is obliged to maintain about $8 of capital for every $100 of assets (12.5:1 leverage), while a conduit issuing ABS, with the benefit of some structural and credit-rating alchemy, may hold $100 of assets with a $3 sliver of capital (33.3:1 leverage). This effectively permits the same amount of capital to support a much greater loan volume.

So long as asset values were stable, heightened leverage was seen as a splendid way to amp-up sponsor returns. Unfortunately, when asset values declined, securitization sponsors and ABS investors were rather harshly schooled in the downside of both leverage and overstated credit quality. In turn, the global securitization market and the ratings

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agencies (the arbiters of quality) have been badly discredited. For that reason, the volume of new ABS in the past twelve months has been a mere trickle (5.8%) of the 2006 peak.

LOOMING REALITY

Many loans funded with ABS during this period of easy credit are maturing without being fully amortized, thereby creating a wave of demand for the only game in town, the banks. This wave of refinancing demand will hit the bank market beginning in 2010 and continue through 2015.

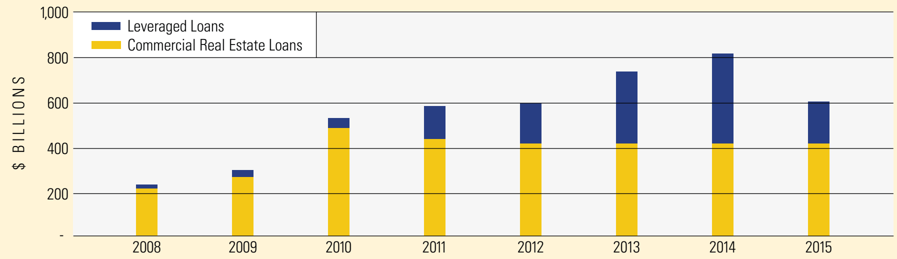
The rub in moving ABS assets to bank balance sheets is that the underlying capital requirement more than doubles. Banks are currently capital-constrained as the result of falling asset values and ongoing credit losses. Capital only grows as earnings are retained and/or new investment is attracted. The prospects are nil for restocking the banking industry with sufficient capital to absorb both the as yet unrecognized problems in existing bank portfolios and the assets expected to roll out of mature or defaulted securitizations. Rising interest rate pressure from government fiscal and monetary policies could further complicate the situation.

As we move through this four- or five-year refinancing period, middle-market borrowers will compete directly with all of those assets for scarce bank capital. Like any limited resource, bank capital will be allocated based on price. No one will want to be at the end of the line.

FINANCING STRATEGY DISCONNECT

There is a notable disconnect between the financing approach and actions of managers of both public and private equity-owned companies, on one hand, and CFOs and Treasurers of privately held firms, on the other. Public and private equity-owned companies have raised more than $700 billion of long-term debt in the bond market, either to refinance looming bank-debt maturities or to stockpile liquidity. With nearly $32 billion on hand, Microsoft recently accessed the bond market to raise $3.7 billion of new capital. At the same time, private equity firms are diligently working to amend and extend the credit facilities of their portfolio companies. To accomplish this, they are paying hefty fees, accepting meaningful hikes in credit spreads, and, in some cases, allowing credit availability to be ratcheted down. These managers see some urgency in this effort and are quite willing to trade dollars for time.

Looming Credit Maturities



WHAT TO DO?

In our view, banks have not surfaced all credit problems in their portfolios, implying further erosion of scarce capital. With a looming wave of financing needs, bankers will have plenty of options for employing their limited capital and will price it dearly. Middle-market borrowers face the prospect of competing for that scarce resource. Many companies, particularly those with above-market leverage, are subject to more refinancing risk than they likely appreciate. With these challenges in mind, prudent business owners and managers should act now to:

- Work with lenders to extend the maturities of existing credit arrangements, even at the cost of extension fees or a hike in the credit spreads;
- Develop back-up alternatives. Cultivate relationships with multiple lenders to create familiarity with the industry, business, and management team; and
- Consider raising junior capital. Ready access to liquidity in a tight market is a potent competitive advantage.

When credit is tight, hope is not a strategy and complacency is the enemy of success, perhaps even survival. ❖

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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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