

Leveraged Finance:

U.S. Corporate Credit Quality Will Likely Improve As Changes In Leveraged Finance Take Hold, Says Investor Panel

Leveraged Finance & Recovery:

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U.S. Corporate Credit Quality Will Likely Improve As Changes In Leveraged Finance Take Hold, Says Investor Panel

Credit quality among U.S. corporate and industrial borrowers will likely improve and the default rate will continue to decline as an economic recovery strengthens, though risks to this scenario remain, said panelists at Standard & Poor's Ratings Services' Leveraged Credit & Recovery Conference in New York. The panel was hosted by Standard & Poor's Managing Director Bill Chew. (For conference audio/video presentations, copy and paste the following URL into your Internet browser: <http://event.standardandpoors.com/content/bls2010>)

The Panelists Foresee Improving Credit Measures...

Nonfinancial corporate borrowers have trimmed their spending since the onset of the financial crisis in late 2007, and the U.S. economy has slowly pulled out of recession, which augurs well for creditworthiness, the panelists said.

"Businesses have done a lot to adjust--a lot of cost cutting--and they'll get the benefits of that over time," said Jonathan Insull, managing director of the Bank Loan Group at Trust Company of the West. "My expectation is that we'll see a steady improvement."

Mr. Insull added, however, that the "survivorship effect" of a number of companies having already collapsed has inflated the improvement of aggregate credit quality. "The weak ones have already fallen out of the herd," he said.

Martin Fridson, CEO and chief investment officer at Fridson Investment Advisors, agreed, suggesting that short of a double-dip recession in the U.S., "everything points in the direction of at least modest improvement during 2010."

"I would say the real question is, 'Why would we not see improvement?' given that we have recovery," Mr. Fridson continued. "Not a roaring recovery, but we're moving in a positive direction."

Still, borrowers face some macroeconomic hurdles, noted Michael Zupon, co-founder of private investment firm Sound Harbor Partners. Mr. Zupon said that sustained high unemployment may continue to hurt consumer spending, rising interest rates may weigh on speculative-grade borrowers because of their high leverage, and sovereign defaults may shock the global financial system.

Additionally, certain industries will likely continue to struggle--media and auto-related sectors among them, said Scott Page, head of the Bank Loan Investment Group at Eaton Vance. These are "secular stories--not GDP stories," stated Mr. Page, adding that he was surprised the recent credit crisis wasn't worse than it turned out to be.

"Yes, the recession had an impact, but it was totally overwhelmed by illiquidity and crisis thinking, and the inability to tap markets," he said. "I expect things to improve. What I find really remarkable is that, absent a couple of sectors, they didn't really get that bad."

"It wasn't like we saw huge moves in profitability or debt that created dramatically different pictures before the recession and in the middle of the mess," Mr. Page said.

He also remarked that, judging by measures such as debt-to-earnings ratios, it was "really amazing how little things changed."

...But Potential Pitfalls Remain

While the panelists at the Feb. 25 conference expect corporate defaults in line with Standard & Poor's forecast of 5% over the next 12 months, some pointed to the surge in refinancing needs in the next few years as a potential pitfall. As interest rates begin to rise and companies look to refinance after the freezing of the capital markets from late 2007 through the end of 2008, some speculative-grade borrowers may find it difficult to find lenders.

Sound Harbor's Mr. Zupon said that a "massive crowding out" of such companies by sovereign borrowers, banks, and investment-grade entities, as well as a greatly diminished market for collateralized loan obligations (CLOs) and an "injured" U.S. banking system, could compound refinancing difficulties.

"There is the potential for that default experience to be completely off the radar of what our common metrics would cause us to conclude," he said.

TCW's Mr. Insull agreed, saying that refinancing needs could keep the default rate at an elevated level as banks try to reduce their exposure to revolving credit. He added that, with the economy rebounding only slowly, companies may not be able to grow fast enough to deleverage and improve their credit quality quickly enough to survive.

Mr. Fridson's default forecast was lower, and he pointed to the decline in the proportion of the market that is trading at distressed levels (defined as more than 1000 basis points over Treasuries). The percentage is now in the low teens after surging as high as 87% when things were at their worst. His firm's market-based default rate predictor suggests a default rate over the next 12 months of 3.8%. But he added that the drying up of the traditional loan market has created the need to transfer capital from one asset class to another.

"Until we see CLOs come back, bonds are going to be the dominant area," he said. "I would think anyone negotiating a loan would have to see that as the competition, and it would make it hard to push stricter covenants on an issuer who can say, 'I'll go to the bond market as an alternative.'" He added that because companies sold bonds predominantly to push out maturities, "the bigger questions will come down the road."

He also suggested that some of the void may be filled by prime-rate funds--generally, mutual funds that invest in corporate loans and pay shareholders interest that is designed to mimic the prime rate, which banks use to price loans to their most creditworthy customers.

Regarding speculative-grade bonds, Sound Harbor's Mr. Zupon pointed to the "massive inflows" of approximately \$21 billion of capital into the market last year, which made for record issuance, saying that low interest rates had made investors reach for yield. But he cautioned that rising rates may cause outflows this year and said that it was incumbent on central banks to keep borrowing costs low enough to prevent a squeeze through the debt maturity cycle.

He added that, in any event, the "size of the bank loan market will be exactly the size of supply at all times," because it's the lowest cost of capital for borrowers. Regarding alternative funding sources, Mr. Zupon opined that hedge funds might step in a bit more, but the incompatibility of their short-term financings with longer-term holdings would mitigate their presence.

Eaton Vance's Mr. Page said that the risk-return ratio on bank loans may once again look attractive to investors at some point, and that loans may become more bond-like, since the importance of covenants has been greatly overstated, and strict covenants may not even be in the interest of creditors.

"You can stop the music early in a credit cycle--sometimes with disastrous results," he said. "If you're a debt manager, it's probably better to let a company get closer to the light. Our experience has always been that recoveries are stronger late in the credit cycle, rather than early."

Mr. Page said that while the total of upcoming maturities may look daunting, it should be viewed on a company-by-company basis, and suggested that worthy borrowers would gain access to the capital markets in one form or another.

"Solutions will be found as problems arise--whether it's the high-yield bond market, whether it's selling the company, or whether it's the bank loan market," he said, adding that rising interest rates won't likely be a big problem because they're rising from essentially zero, and any increase in borrowing costs implies an improving economy, the benefits of which would offset the rise in rates.

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