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LENDING SOUNDNESS

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Monthly Market Insights

Decoupling of stock markets and economies

As tech and many life science stocks had an impressive run over the last couple of months especially, it is hard to see the stock indices moving towards a more balanced sector composition in the near future. Looking at factors driving the de-coupling of consumer and fundamental corporate performance / outlook vs. market valuations, it is indeed the relative dominance of the S&P 500 by the IT sector as well as the FED's two funding programs to mitigate the impact of the pandemic.

While the FED and ECB and other central banks are committed to providing companies with liquidity, these commitments propped up stock markets by reducing / delaying bankruptcy risk and potentially speeding up the economic recovery. Consumer sentiment, on the other hand, has yet to show signs of recovery. With both sides moving in opposite directions, it is possible the de-coupling could grow even larger before a - likely painful - re-coupling sets in.

Portability is sneaking its way into sponsored M&A

The ultra low rate environment continues to fuel the quest for yield and weakens the negotiation power of creditors when it comes to their right to have their loans repaid in the case of an acquisition. Private equity firms have increasingly been able to implement so-called "portability language". The development makes it easier for them to sell leveraged companies. While debt investors are unhappy about weakening their seat at the table, the lack of alternatives leaves them with little choice but to accept. Portability increases the attractiveness of a company, as potential acquirers can be assured that financing is already in place and transaction time and costs are reduced. Portability can also open doors for acquirers unable to obtain the required capital structure and cost. After the global pandemic struck in March, chances were high investors would obtain more power and lending standards would improve. The sharp recovery in credit markets, boosted by massive central bank intervention, is however far from seeing this happening.

Leveraged transactions thrive as risk aversion declines

Following pandemic driven weak activity, private equity firms are actively returning with highly levered transactions in an environment that's short of new supply. Current September issuance volumes, just shy of USD 32 billion, have reached a three year high in the US and are well on track to reach new highs for these types of deals since the last financial crisis. Dividend recapitalizations, which refinance debt as well as fund payouts, account for about a quarter. In some cases sponsors are able to recoup large amounts of their initial investments. Mostly the transactions cause leverage to skyrocket and ratings to test new lows.

Stimulus by the FED, ECB and other central banks aimed at minimizing economic fallout from the pandemic will likely limit market volatility for some time to come. High-yielding debt is therefore set to record growing demand despite continued uncertainties and lack of visibility, while private equity firms continue to make hay while the sun shines.

Pandemics and leverage don't go well for long

Buybacks regularly form part of policy discussions. The focus thereby is set on capital structure dynamics in economic- and financial cycles, and financial intermediation capacity. Management can decide to pursue high leverage for various reasons, such as optimizing the cost of capital or focusing on short-term results vs longer-term costs of distress, especially if these are shouldered by creditors, employees, and the public. In this case, high leverage is part of a strategic choice. The pandemic fallout set the spotlight on leverage and companies' capacity to weather the storm. Companies with high leverage - irrespective of past buyback activity - recorded considerably lower returns than their lower-leveraged peers during the pandemic so far. According to the big 3 rating agencies, defaults are set to accelerate, likely questioning the permissive stance over buybacks by some, while defining the strategic agenda on balance sheet resilience for others.

Elliot's highly leveraged bid for Swiss based Arytza

Billionaire Paul Singer's Elliott Management Corp. is exploring a bid for the ailing Swiss baking company Aryzta AG that has separately been attracting interest from private equity suitors like Apollo Global Management and Cerberus as well as Canadian grocery and baking giant George Weston Ltd. Shares of Aryzta have fallen 46% this year, giving the company a market value of about 586 million Swiss francs ($648 million). Elliott's deliberations are at an early stage, and there's no certainty it will proceed with a formal offer. Aryzta hired Rothschild & Co. this year to conduct a strategic review. Swiss firms have been involved in $40.3 billion of M&A this year, down 33% from 2019.

Elliott, known for activist investments where it purchases stakes in public companies and agitates for change, also has a private equity arm that buys struggling firms and fixes them up itself. Last year, it bought Barnes & Noble Inc. after previously acquiring British bookstore chain Waterstones and network-technology company Gigamon Inc.

Everything comes to those that can wait

In the wake of one of the largest credit booms in history, Private Equity focusing on leveraged buy-outs have been conspicuously absent. Despite the very favorable financing environment and large dry powder piles buy-out activity has been subdued. While pandemic related uncertainty is often cited as reason, this is just one side of the coin. The massive central bank and government interventions have boosted valuation levels past hurdles allowing making sense. Deals banks were stuck with for some time have been passed on with backlogs deceasing, growing loan book capacity.

As Private Equity players are starting to revisit buy-out opportunities, one of the key questions therefore centers around an expected "re-coupling" of valuation levels vs. corporate fundamentals more reflective of the economic environment and outlook besides having gained more visibility on pandemic-related winners as we head further down the road.

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