Leveraged Finance: The Eternal Ticking Time-Bomb?

Introduction

2022 has been a difficult year for investment banks. Despite the relative strength of their trading divisions, a collapse in M&A value has been weighing down on revenues. Something that has been leading to outright losses, however, is Leveraged Finance. This lesser-known part of the financing groups at investment banks has been the driver behind hundreds of millions of dollars' worth of losses, with the potential of billions more to come. Such losses naturally raise the question of how you can lose so much money and how the business works. Also, we will look at whether these losses are unavoidable, in order to shed some light on the investment banking division that gave rise to leading bankers, such as David Solomon, Goldman Sachs' CEO.

An Introduction into Leveraged Finance

Leveraged Finance refers to the debt financing of highly levered, speculative companies. Specifically, Leveraged Finance, or LevFin as it is known in finance circles, provides financing to companies that are rated as 'non-investment grade' by the major rating agencies. Such companies have higher Debt-to-Equity ratios and lower interest coverage ratios, making them risky. Precisely this focus on non-investment grade debt is what distinguishes LevFin from the Debt Capital Markets division that focuses on investment-grade debt. Also, LevFin distinguishes itself from Corporate Banking by focusing on junior loans and syndicated debt. The group's mandate of financing levered companies allows it to refinance high-yield bonds, finance highly levered mergers and arrange dividend recaps. However, the bread and butter of this division is financing leveraged buyouts, especially as the private equity industry continues its growth.

When financing a levered buyout with a syndicated loan, the bank promises to provide a certain type of debt financing at a given interest rate with some covenants. With this promise of financing, the bid becomes more attractive for the target, as it knows the financing sponsor can get the deal done. If the deal is then agreed, there is a time-lag between the firms agreeing to do the transaction and the deal being closed, as some due diligence has to be done and there may be some regulatory intervention. When the deal is then finally closed, the loans are underwritten by the bank, the money is transferred to the financial sponsor doing the deal, and the bank starts trying to syndicate the debt.

As we have witnessed recently, market environments can change substantially between the time that the bank agrees to underwrite a deal and when it actually has to provide the money and syndicate the debt. Hence, it could agree to underwrite a very risky deal in a bull market but have to syndicate that risky debt in a downturn. To compensate the firms for this risk, they get paid substantial fees, ranging from 1-5% of the loan value, depending on how complicated the transaction is. In a vanilla leveraged buyout, fees tend to be on the lower end of that spectrum.

In an ideal world, the bank can syndicate the debt on the terms it previously agreed on with the financial sponsor. This means that the debt is sold at or close to par and the deal is profitable to the bank, as it keeps its fees. If, however, the bank tries to syndicate the debt and receives insufficient interest from investors, it will have to

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improve the terms for investors. At first, this is covered by the 'flex' that the financial sponsor provides the investment bank. This means that the first bit of 'sweetening' that has to be done to sell the loan, including offering it at a discount and strengthening the covenants, is covered by the financial sponsor. Frequently, something like the corresponding discount to the first 100 basis points increase in interest rate is covered by the financial sponsor. Hence, this outcome is still good for the bank, which still collects all of its fees. Some deals, even with the discount provided by the flex, don't attract sufficient investor interest. This means that further discounts have to be offered to investors, which now have to be covered by the investment bank itself. Hence, the money the firm now makes on the deal is the fees it collected minus the amount of money the firm had to spend to make up for the difference between the money it raised and the money it promised to raise for the financial sponsor. The firm raised less money than it had originally intended to, as it had to sell the bonds it created at a discount. If the discount the bank has to provide is large enough, it will exceed the fees it generated through the deal, meaning it will take an outright loss.

As the bank has to pay for the discount on the bonds itself, the question is raised why the firm doesn't wait for market conditions to improve to syndicate the bonds at better terms.

Why are banks selling leveraged loans at a discount?

Banks prefer to sell the loans and not keep them on their portfolio for an extended period because of missed opportunities and risk regulations. In the post-2008 financial world, risky lending practices have been heavily regulated by competent authorities with the aim of preventing another debt crisis from happening. The Large Exposures Framework is set under the Basel capital standards, which enforces that significant risk debt must be lower than 25% of the available capital base, while for important global banks like JP Morgan and Goldman Sachs (G-SIBs), the risk exposures must be as low as 15%. As a result, banks cannot pile up an infinite amount of leveraged loans on their balance sheet or they risk not being allowed to underwrite any new loans by competent authorities and, as a consequence, lose potential business.

Another guideline set by the Fed that pushes banks to sell at a loss is that during and LBO process, the acquired companies' debt should not be more than 6X EBITDA (net leverage ratio). As of November 2021, more than 30% of new leveraged loans breach these guidelines, which in times of abundant liquidity would have not affected the loan selling process; however, as the risk appetite of investors is decreasing, possible buyers in the LevFin market expect a discount when dealing with these overleveraged companies. As a result, banks face a big dilemma concerning their risky loans: sell at a discount or keep the loans on the balance sheet and stop the underwriting process. Even with high-risk debt trading at 94 cents on the dollar as of August 2022, most banks still choose the former, taking the loss and keeping the deal flow steady, as, in the long run, it will be more beneficial to keep clients happy and underwrite more loans.

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The Morrisons deal is particularly representative of the current situation in the Leverage Finance Market. With CD&R and Fortress battling in 2021 to acquire the US grocer, the bid price soon reached £10 bn, with banks like Goldman Sachs and Bank of America hooked on more than £6.6 bn of debt. The banks told investors that the deal was supposed to leave Morrisons with 4X net leverage- under the 6X recommended by the Fed; however, the bankers heavily adjusted these calculations, and increased the EBITDA by more than £450 mn by adding back "exceptional items". Even with these financial adjustments, investors were reluctant to buy the loans, and as a result, Goldman sold £1.2 bn of junior debt to Canada Pension Plan Investment Board for 94 cents on the dollar, taking a loss of £50mn and another £1.5 bn was sold to a few investors at a loss of £150 mn. As the original deal went through, the lending banks were entitled to £63 mn worth of fees. As of 2022, banks were hoping that bond prices would recover; however, the price of Morrisons' bonds plunged further down and are trading as of August 2022 at 80 cents on the dollar, with some estimates marking them as low as 50.

There are a few exceptions from the rule of selling loans to investors in distressed markets. JP Morgan has decided to set up a unit to hold leveraged loans on its balance sheet to maturity rather than underwriting the debt for syndication, given its size, record profits in 2021, and willingness to compete in the $500 bn direct lending industry. Also, BNP Paribas has opted to hold its Morrisons bonds on its balance sheet, given its strong corporate banking division, and the downside of extremely high losses.

Have we seen this before? Is it typical in a downturn?

The inherent danger of our current predicament is only made worse by financial history, notably during the financial crisis. The development of collateralized debt obligations (CDOs) and other forms of securitization fed the LBO boom that lasted from 2004 to 2007. Bank lending practices connected the LBO and CDO markets, as seen by the increased lending for LBOs from banks engaged in structured credit underwriting. Less spreads and more usage of bank debt in deal financing were linked to LBO loans originated by largo CDO underwriters. The LBOs, overpayments, or riskier deal structures that resulted from loans secured through structured credit markets were not worse than the alternative, and the LBO boom was fuelled by securitization markets, which altered banks' access to financing and impacted their lending practices.

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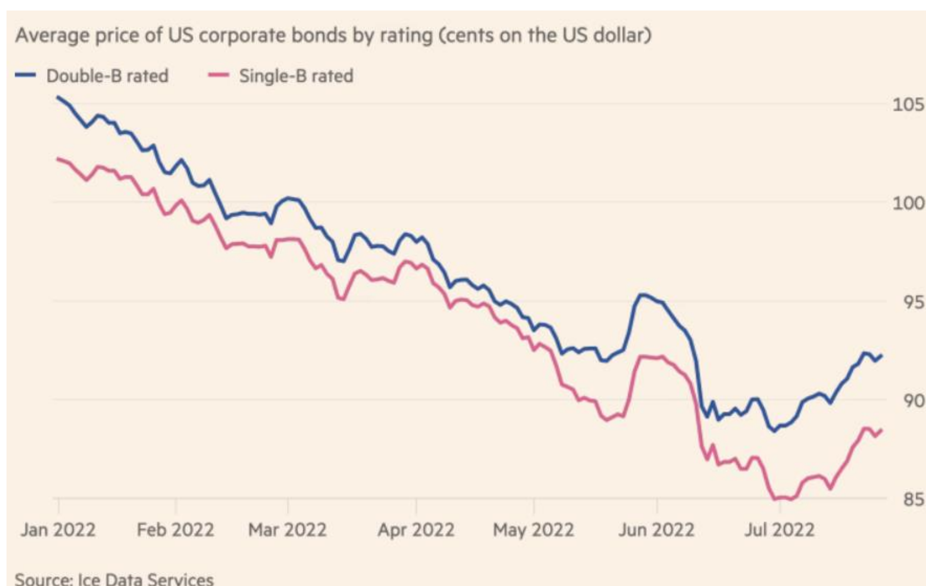
Similar to how Morrisons is currently battling to offload its debt, KKR outbid Guy Hands in 2007 to buy out Alliance Boots for £11 billion and subsequently struggled to do the same. One may argue that this marked the zenith of pre-crisis European private equity hubris. Almost £9 billion in debt was used to pay for the £11 billion transaction, and a group of banks partnering with KKR failed to sell 5 billion GBP in senior debt to finance the acquisition shortly after the deal closed, leaving it stuck on their balance sheets. They had to raise interest rates as a result in order to sell their junior debt and take out so-called "bridge loans" (typically taken out for a period of 2 weeks to 3 years while waiting for the arrangement of larger or longer-term financing, in this case as a result of the crisis). Banks realized that if they were forced into this situation in the first place, they were most likely underwriting too much debt, which is why the Boots transaction represents the final mega deal of the era.

We are seeing history repeat itself, with tens of billions of dollars' worth of debt stuck on bank balance sheets left over from financings that had been struck before a sell-off rattled financial markets and a slowdown gripped the global economy. Corporate bonds are accelerating their value depletion, causing investment banks to take huge losses on financing packages not yet being funneled to the general public. This is due to interest rates shooting higher, and Investors beginning to bet that the Federal Reserve would need to dramatically tighten policy to curb inflation, a move that has been sending bond prices tumbling, including the debt banks were holding on their own balance sheets to fund deals. In quick succession, Russia's invasion of Ukraine and lockdowns in China to slow the spread of Covid-19 hit markets, and investors began to prepare for recession.



Back to 2008, when the banking crisis and the world recession simultaneously occurred within a year, sceptics anticipated that the Boots transaction would be financially disastrous, but Pessina had the insight to realize the stability of Boots' cashflows. The sector of the retail economy that was most resilient to the recession was healthcare. Additionally, the requirement that millions of consumers visit Boots pharmacies each week to pick up their prescription medications was a big aid to stabilizing the transaction. KKR performed well in terms of the 2007 take-private, even though it took them ten years to sell to eventually sell to Walgreens, a cautionary tale.

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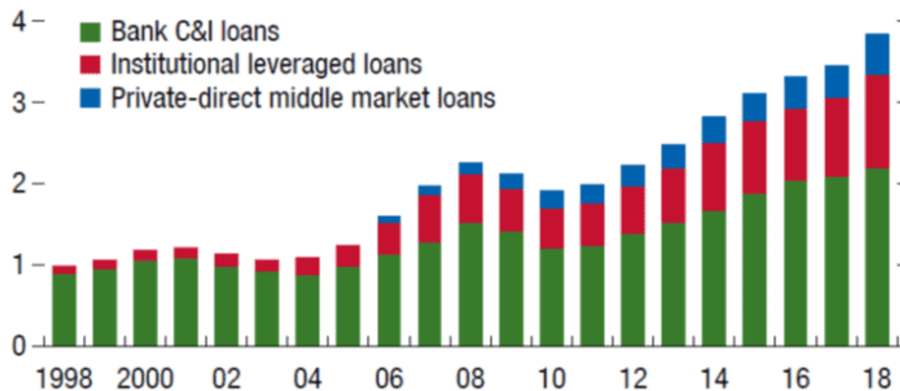
They were not alone, as at least 35 companies postponed or restructured bonds and loans in the five weeks preceding the beginning of August 2007 as borrowing costs rose sharply off the back of record defaults on U.S. mortgages. In many ways, the leveraged market of today is similar to that of 2007–2008. Leveraged loans have more than doubled in volume, leverage levels are higher than they were before the crisis, refinancing risks have been steadily rising since 2017, non-bank lenders are the most aggressive in the market at c. 85% of leveraged loans being held by them (comparable to subprime lenders during the crisis) and CLO issuance has increased significantly, comparable to mortgage-backed securities in 2008. Across the board, leverage has decreased but debt expenses have increased. Multiples could remain lower for a longer period of time without the resumption of free money flowing from the central bank.



Conclusion

Because of their decision to delay their high-yield bond and leverage loan offerings until after Labor Day in anticipation of greater levels of market receptivity, many banks are currently re-learning that participating in leveraged finance is essentially setting off a time bomb and that they must sell their debt as quickly as possible (the post Labor Day market is not more receptive, and banks are back to square one). It's crucial to keep in mind that investors in private equity funds are typically committed for years, not months, and that banks willingness to support future private equity buyouts in the short and possibly even the long term will depend on how difficult this debt will prove to be to offload. This makes it possible for private credit to flourish, as it typically does during times of market turbulence, begging the question of how long banks will continue to suffer the consequences of their underwriting rollback in terms of their finances as well as their relationships with financial buyers and their ever-changing appetites.

TAGS: Leveraged Finance, Banks, Investment Banking, Goldman Sachs, Morrisons

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