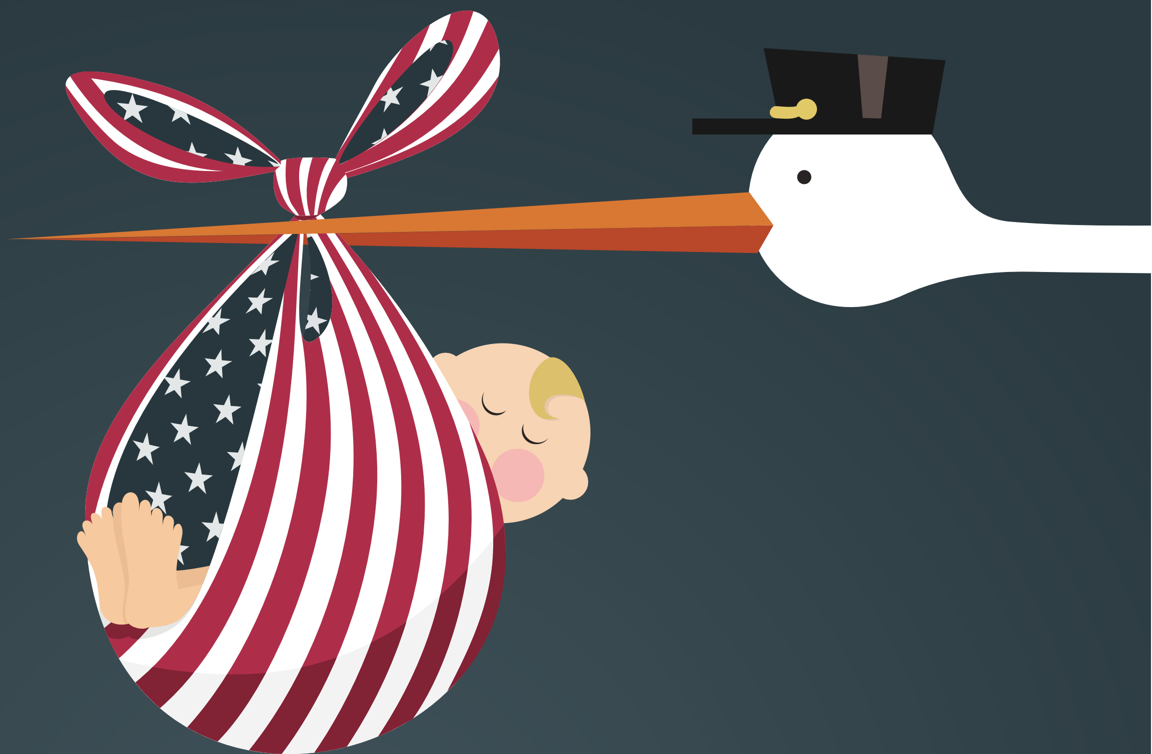

What Can We Expect?

The U.S. Finance and Capital Markets in 2010 and Beyond

BY THEODORE L. KOENIG

Now that we have all lived through the Great Global Recession and are still around to talk about it, where do we go from here? What should we expect from the U.S. financing and capital markets in 2010 and beyond? Where will liquidity come from, and who will provide jobs in this new economic paradigm? What will the government do with interest rates given the massive support it has provided to the banking system, and where will new investor capital come from and where will it go? How will all of this affect us?

The questions on the previous page are ones that we have all thought about over the last couple of months. Whether an asset-based banker or other lender, leveraged-capital provider, private equity sponsor, bankruptcy specialist, turnaround professional, attorney, appraiser, investor or borrower, all of us have a vested interest in functioning capital markets and the answers to these questions. This article attempts to provide meaningful answers to these important questions and an outlook on what's to come.

Will unemployment improve?

Unemployment is hovering around 10% and will probably continue to do so. The lack of change in the unemployment rate will be due in large part to the fact that many workers have stopped looking for work. When we include the number of unemployed workers who are not actively seeking new employment, the real unemployment rate is and will remain in the neighborhood of 17.5%. That means the U.S. economy will need to create 150,000 new jobs per month just to absorb those returning to the labor market. The continued lackluster job growth, which will likely extend well into 2010, will place downward pressure on wages and help moderate any inflationary tendencies from the massive government intervention and stimulus we witnessed in 2009.

Banks, however, will wake up to the fact that they need to grow assets and create spread income again. Market share and league table rankings will again be meaningful statistics in Monday-morning management committee meetings. This revelation will probably occur in mid- to-late Q2 2010. As a result, large money-center banks, super-regionals and regional banks will aggressively reenter the commercial and industrial (C&I) loan market as they attempt to deemphasize and diversify away from real estate assets. The smart money is betting on the banks that will be able to grow their C&I loans quickly at attractive spreads while increasing deposits and reducing their reliance on real estate loan holdings. This phenomenon will result in a spike of hiring back into jobs that were eliminated in 2008 and 2009, particularly loan originators. My advice to those lenders now working at turnaround-consulting firms or on the beach is to dust off your resumes and start your engines. I think banks will be hiring in Q2 and Q3 of 2010.

Where will interest rates go?

In 2009, the Federal Reserve (Fed) decreased the fed funds rate to near zero, a historic low. This dramatic reduction was intended to prevent the economy from sliding into a depression. With the economy now largely stabilized, the question becomes how much longer the Fed will allow the fed funds rate to remain near zero.

It appears that the Fed is inclined to allow interest rates to remain near zero for the foreseeable future. As scholars of the Great Depression point out, the Fed's willingness to raise interest rates as soon as the economy demonstrated sustained growth and viability contributed to the second, more painful economic downturn in that period, which many people believe ultimately caused the Depression to drag on even longer. To avoid any threat of causing the same sort of event now, the Fed will be willing to tolerate the potential inflation risks in order to force economic growth.

In addition, low interest rates appear to be helping stabilize the economy. For example, low interest rates have translated into lower rates for consumers on everything from credit cards to home mortgages and home equity loans. These lower interest rates encourage consumer spending, economic growth and, more important, an increase in home purchases, which ultimately drives the U.S. consumer economy. Finally, many companies, including small businesses, already have and will be able to take advantage of lower interest rates to refinance their debt.

For these reasons, and given the slow pace of recovery to date, the Fed should be inclined to keep interest rates near zero for most of 2010. In late Q3 and

THE BASICS FOR 2010

- **Money-center, super-regional and regional banks will aggressively reenter the commercial and industrial loan market.**
- **Fed should be inclined to keep interest rates near zero for most of 2010.**
- **High-yield issuance is likely to continue at elevated levels.**
- **An area of the leverage loan market that will be particularly attractive is the middle market.**
- **Large, mid-size and small banks will participate in the Great Renewal of the ABL business in 2010.**
- **The new bankruptcy landscape will be a much shorter process.**

early Q4 of 2010, we will likely begin to see a modest increase in interest rates as the word "inflation" begins to appear in the economic discussion. However, the Fed tends to be patient and will probably wait to see improvement in consumer spending, favorable employment statistics and a rebound in housing starts before increasing interest rates.

What will happen in the high-yield market?

The high-yield market had a banner 2009, with returns on high-yield bonds near 50% for the year. A rally from distressed prices largely drove the returns, with prices of high-yield bonds appreciating from lows of close to $60 in late 2008 to the upper $90s by the end of 2009. One of the key drivers of high-yield demand in 2009 was the long drought in high-yield bond issuances in recent years, which was caused by the growth of the leveraged loan market over the past decade. As syndicated loan issuances increased and demand for structured assets such as collateralized loan obligations (CLOs) increased, high-yield bond issuances dropped off.

However, money moved back into high-yield mutual funds in 2009, increasing demand for these bonds. In response to this demand, high-yield issuances in 2009 were more than triple those of 2008, with a number of structural changes taking place: Original issue discounts (OIDs) to increase yields became commonplace, the issuance of secured notes increased to retire secured loans and maturities and durations on new high-yield issuances fell from an average of 7–10 years to 5–7 years.

In 2010, high-yield issuance is likely to continue at elevated levels for a number of reasons, including the continued refinancing of leveraged loans with high-yield bonds, large sums of capital shifting from lower-yielding assets to higher-yielding assets as investor risk tolerances increase, and an increase in M&A and LBO activity. Investors are likely to continue to shift toward riskier asset classes in search of yield.

Returns on high-yield bonds in 2010 are likely to range from 10% to 14%, driven primarily by coupon interest payments rather than by the price appreciation that fueled the stellar returns in 2009. The recovery from distressed prices has already largely taken place and OIDs on new issuances have been shrinking, a trend that will continue. There may still be, however, some room for price improvement. The spread on high-yield bonds implies a default rate higher than the worst period of cumulative defaults (1987–1992) in history. Further spread compression could help the high-yield market continue to perform well in 2010.

What can we expect from the leveraged loan market?

As was the case with high-yield bonds, leveraged loans offered returns in excess of 50% in 2009 because unprecedented low prices in late 2008 recovered to the low-to-mid 90s by the end of 2009. Meanwhile, new borrowers were forced to offer additional incentives in order to attract capital, including significant OIDs and LIBOR floors. New issuances of leveraged loans, however, dropped off significantly in 2009 as corporate issuers extended debt maturities by refinancing their loans with high-yield bonds.

Although high-yield bonds will continue to displace leveraged loans in 2010, primary issuances should increase on an aggregate basis, with the majority of new issuances driven by refinancing existing loans and funding needs for M&A activity. Companies coming out of bankruptcy with large exit facilities will fuel additional demand for leveraged loan issuances. A familiar source from just a few years ago — collateralized loan obligations (CLOs) — may fund the demand for these loans. The $440 billion market for CLOs disappeared in 2007 but is poised to make a comeback as market conditions improve. JPMorgan Chase, Bank of America, Wells Fargo and Citigroup will all be in the game when the starting gun fires.

Returns in the leveraged loan market in 2010 will be much lower than 2009 due to the price recovery from all-time lows. However, returns in 2010 should be strong, likely ranging between 7% and 9% and resulting from incentives such as LIBOR floors and OIDs, which borrowers will continue to include in new issuances. The potential for double-digit returns in 2010 will exist, particularly among lower-priced LBO loans that have sponsor support, distressed or defaulted loans that have turnaround potential, and second-lien term loans for healthy borrowers with attractive coupons.

An area of the leveraged-loan market that will be particularly attractive in 2010 is the middle market. Although the overall leveraged-loan market returned over 50% in 2009, middle-market loans returned only 33%, marking the first time since 2002 that the middle market failed to outperform the broader market. Reasons underlying this discrepancy include the fact that the market for middle-market issuances is highly relationship-driven and more of a club buy-and-hold strategy effort for many market participants and thus is more resistant to many of the technical factors of the broader loan market. Further, middle-market loan deals typically run on a slower clock and lag those of large-cap borrowers. Because of this lag, many middle-market loans continued to perform in 2009 and were not subject to the same drop-off in secondary loan pricing that the broader market experienced; hence the price recovery curve was not as steep.

What about the asset-based lending market? What can we expect to see there?

Like the leveraged-finance debt markets, a coming refinancing tidal wave will drive the asset-based lending (ABL) market in 2010 and beyond. Pent-up demand, lack of institutional leverage loans and money-center banks' voracious appetites for new assets (due in large part to their receipt of government stimulus money) will drive the ABL market to new highs in 2010. Fewer participants (due to consolidation at the high and middle portions of the market) will keep pricing stable and above historical levels. Conservative effective advance rates and moderate loan covenants will also help create a strong and resilient ABL product. Large, mid-size and small banks will participate in the Great Renewal of the ABL business in 2010.

Also in 2010, we will witness the bifurcation and the stratification of the ABL market by loan size and debt provider. Banks will continue to finance the larger transactions and the better underlying credits at aggressive rates. They will compete for these credits but also club them among themselves to provide seamless market execution. However, an opportunity will arise for smaller, new finance companies to form and become a factor in this business due to the system's overall lack of capacity. This same phenomenon occurred after the market meltdown in 2000.

Available pricing and relative security in the collateral of good companies that have been shut out of the financing markets for no good reason will attract new, yield-seeking investors into this space. Private equity funds and others seeing a need for this product in the market (and coincidentally sitting on large amounts of uninvested capital) will be the likely source of the underlying capital needed to jump-start this new business segment. Banks will come to provide the discount leverage necessary at reasonable multiples and rates because this type of warehouse lending is highly accretive with strong individual borrower diversity and low overall portfolio risk. Expect to see new C corporations formed in this space, hoping to grab market share in 2010 and 2011 with the intention of creating a capital markets exit in 3–5 years. Yes, we have seen this movie before....

Given the foregoing, ABL will again become a hot area in 2010.

Will second-lien and mezzanine debt be a factor?

Both second-lien and mezzanine financing should make strong comebacks in 2010 and 2011. For the same reasons that these products were rock stars in 2000–2005, they will sing again. Fueled by the lack of available leveraged-finance debt capital and ABL's increasing market share, a financing gap will probably reappear on the balance sheets of many companies. Just as in the last cycle, when our firm was fortunate enough to play a role in this asset class, again there will be opportunities for intelligent providers of private debt capital to create a layer in the capital structure between the ABL (on top) and the private equity sponsor below. This layer should offer an excellent risk-adjusted return for fixed-income investors seeking yield. Expect to see pension funds, insurance companies, sovereign wealth funds and other foreign investors that search for low risk, higher-yielding securities to enter this market in 2010 and drive demand for this product for the next several years.

There are many reasons for borrowers to embrace this type of private debt capital as well. Among them and most important is certainty of close. In these types of transactions, borrowers negotiate directly with investors who are committed to funding. Unlike most high-yield and public transactions, a material change in the credit markets will not release an investor from its contractual commitment or allow the investor to increase the agreed-upon yield or spread. This provides issuers and financial sponsors seeking capital for their LBO transactions certainty on pricing, terms and structure. The lack of public disclosure is also a significant advantage. In private negotiated transactions, companies are not required to file disclosure documents with the Securities and Exchange Commission, which allows them to keep financial performance, executive compensation and competitive information private. Borrowers also save the substantial disclosure expenses associated with being a public reporting company. Finally, flexibility is another key attribute. Private negotiated transactions can offer borrowers far more flexibility in prepayment terms, coupon composition, amortization, maturity and covenants.

What are the prospects for turnaround consultants, bankruptcy specialists and attorneys?

Unfortunately, 2010 will be a disappointing year for many turnaround consultants, bankruptcy specialists and lawyers. This will be a direct result of the epidemic that swept through lenders in the U.S. and Europe that I refer to as "AEP Syndrome." AEP Syndrome is closely akin to the H1N1 flu virus in that it affects all who come in contact with underperforming leveraged loan credits and borrowers. AEP Syndrome is brought about by lenders who Amend, Extend and Pretend. There are no signs of abatement in 2010 for AEP Syndrome.

The bright spot for turnaround consultants and law firms in 2010 will be the emergence of private equity firms as the holy grail. As more PE firms try to salvage and recapitalize underperforming companies in an attempt to posture themselves for new fund-raising in 2011 and 2012, they will need to place window dressing on some ugly abodes as they go back to market. They will need to weave a tale of hands-on management and debt-to-equity conversion in many of their portfolio companies. Those standing to gain the most from this display of creative writing will be the turnaround professionals who will be best able to articulate this story and the attorneys participating in debt-to-equity conversions both in and outside of bankruptcy.

A double whammy will also affect attorneys and bankruptcy specialists, however, in 2010 because bankruptcy will just not be the same going forward. The new bankruptcy landscape will be a much shorter process. Reorganizations under Chapter 11 will be increasingly difficult to accomplish. Section 363 asset sales and debt conversions to equity will rule the day, otherwise liquidations will occur. In addition to the effect that the new bankruptcy rules have had on the process (among them, 120 days to either accept or reject leases for properties, adequate assurance of future payments to utilities companies, less time for the debtor to exercise the exclusive right to propose a plan of reorganization), in highly leveraged transactions involving companies experiencing declining cash flow and EBITDA, lenders have no interest or incentive to fund a long Chapter 11 reorganization process. The end result will be a very short and sweet trip through the bankruptcy courts á la GM, Chrysler, CIT, Circuit City, Linens 'n Things, Sharper Image, Steve & Barry's, Merisant, Lyondell Chemical, Citadel Broadcasting and others, much to the chagrin of the bankruptcy specialists and law firms practicing in this field.

The road ahead

The credit markets have experienced unusually broad and intense dislocation in 2009. This crisis has set the stage for a widening gap between the supply of and demand for corporate capital in the form of credit.

The root causes of the supply imbalance stem from a retrenchment among banks, a shakeout of the hedge fund industry, and the closure of the collateralized loan obligation (CLO) and collateralized debt obligation (CDO) markets. At the same time, demand for credit capital in 2010 and beyond will come from several areas including a strong backlog of refinancing, ongoing borrowing needs of companies around the world and private equity funds with substantial amounts of capital to deploy.

In response to this supply/demand imbalance, both traditional and nontraditional sources of debt capital will emerge to help fill the gap. Banks will become more active, particularly in the asset-based finance segment, with aggressive loans against accounts receivable and inventory. Leverage lending will reappear, but modestly at first in response to refinancing activity. Private credit and mezzanine funds will emerge, initially on an unleveraged basis and then slowly taking on leverage, to fill holes in the leveraged finance and cash flow segments of the market. Finally, private equity will enter the credit space and have an effect on restructuring, recapitalizing and equitizing defaulted principal in debt-for-equity swaps. Private equity will also take a leading role in backing new ABL providers as they enter the market.

With regard to each of these solutions, private credit capital targeting the middle market will represent an attractive entry point on a risk/reward basis for investors. Given the lack of alternatives available in the traditional leveraged-finance markets, smaller to mid-size publicly held and private companies will increasingly turn to the private credit markets for capital. As a result, pricing, terms and covenants for these deals will continue to be attractive to investors. TSL

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