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Fixed income focus:

The M&A effect on credit markets

What this year's M&A boom means for credit *- With new mergers and acquisitions (M&A) activity at its highest since 2007, Andrew Swan asked senior fixed income fund managers Dan Gardner and Richard Ryan, who manage M&G's leveraged loan and multi-credit portfolios respectively, what this may mean for different fixed income markets* ***p42***

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Andrew Swan is director of fixed income at M&G Investments

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What this year's M&A boom means for credit

With new mergers and acquisitions (M&A) activity at its highest since 2007, Andrew Swan asked senior fixed income fund managers Dan Gardner and Richard Ryan, who manage M&G's leveraged loan and multi-credit portfolios respectively, what this may mean for different fixed income markets

Andrew Swan (AS): Dan, given that loans exist primarily to finance mergers and acquisitions, this boom in M&A-related activity must have a direct impact on your market?

Dan Gardner (DG): M&A is one of the reasons why loans exist, more M&A activity expands my investible universe, providing additional opportunities.

AS: Why is this boom happening?

Richard Ryan (RR): Equity markets have risen despite no meaningful increases in companies' revenues or earnings. Now company managements are under pressure to justify those higher equity prices by improving their income. There are three main ways companies can do this: grow their businesses organically, increase leverage (which includes buying back shares) or M&A.

DG: M&A is ever-present but goes through waves of very heavy activity, because one high-profile deal can often become a catalyst for several in the same sector.

AS: Do low interest rates also explain the number of deals?

DG: Absolutely. A 'BB-rated' company can get 10-year debt to finance an acquisition at a 5 per cent interest rate. If they manage to buy the right company that can really boost shareholder returns. Finance directors are completely alive to the opportunities that low rates provide.

RR: Yes and also, unlike today, some companies previously would have been dissuaded from M&A activity by the threat of a credit downgrade. But several issuers have recently been downgraded to high yield (i.e. their rating has fallen below BBB) without being punished by debt investors. With the spread differentials between high yield and investment grade at some of the narrowest levels in several years, why wouldn't a company take advantage?

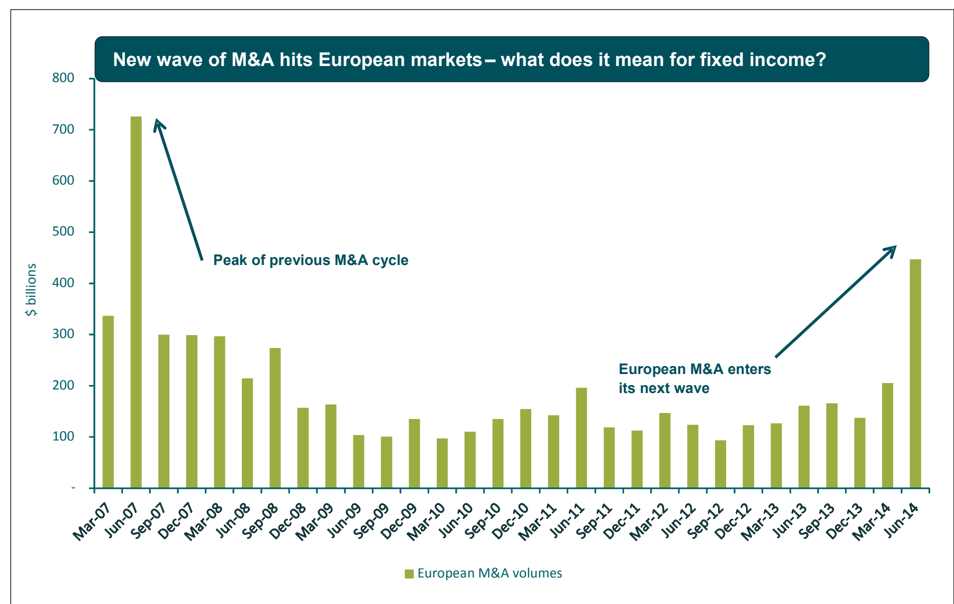
AS: How much of this activity is being financed in the leveraged loan market?

DG: There is definitely a lower proportion being financed in the loan market than in previous M&A cycles. Lots of corporates are chasing growth, so there's at least as much of an incentive for companies to merge with or acquire another company using public sources of finance as there is for a private equity sponsor to finance a takeover.

After Kraft's lengthy takeover of Cadbury in 2010 new rules made hostile takeovers harder. Look at Pfizer and AstraZeneca. As a result, private equity activity is lower. Banks, with an eye on their capital ratios, are less likely to finance a risky buyout.

AS: How bad is M&A activity for investment grade credit?

RR: When investment grade companies engage in M&A, they mostly



Source: Bloomberg, June 2014

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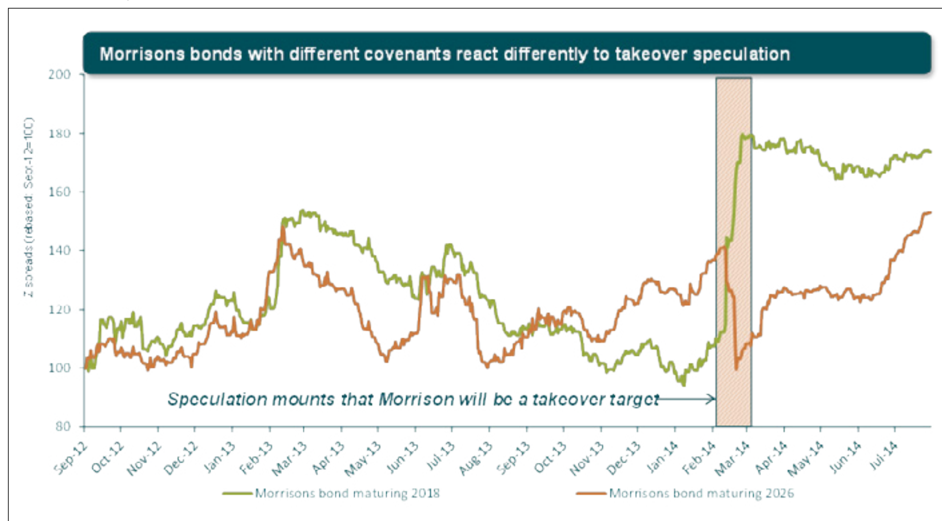

remain investment grade afterwards, so the performance impact is minimal.

But in the minority of cases, you can see a significant impact. If a high-quality issuer takes over a low-quality issuer, and greatly improves its credit quality, that would be a very positive outcome. On the other hand, if a highly leveraged private equity sponsor takes over an investment-grade issuer, then the bonds have suddenly become a lot riskier.

In those instances, there is more to lose than there is to gain for managers running portfolios relative to a benchmark. Contrary to popular belief, 'avoiding the losers' is unlikely to generate significant outperformance because each issuer makes up such a small portion of the benchmark. However, as portfolios tend to be far more concentrated than benchmarks, failing to avoid the losers can be costly.

Covenant protection is variable in investment grade bonds. Morrison's, which has faced speculation as an LBO target, is a good example. Two of its bonds feature 'change of control' covenants, giving bondholders the flexibility to sell the bonds back to the issuer, and the others do not. The performance of the bonds was therefore radically different. Covenants go through cycles in the investment-grade market. When the balance of power leans more towards the investors, you see stronger covenants. Right now, you're seeing covenants start to slip away.

Just as important is the volatility that M&A activity can create. As markets start anticipating changes in structure, leverage and credit quality, we look for areas where the market has over-reacted and then aim to profit from that volatility.

AS: Is it more of a given that you get strong covenant packages in the leveraged loan market?

DG: It is, but nothing exists in a vacuum. Investors need to be diligent because this is where I think pressure might build. In the last M&A boom, we saw credit spreads widen and covenant packages soften. In this boom, because of the shape of the yield curve, I don't think we'll see the former but we are starting to see the latter.

In the high-yield bond market (and not the loan market) you sometimes come across 'portable capital structures'. This essentially means that if the company gets taken over, your issuer can have different leverage metrics than it had when you originally loaned to it, and you have no protection against that whatsoever.

Now, this violates what I consider to be one of the canons of lending: 'know who you are lending to', not just now but in the future. If the issuer I've loaned to gets acquired then I no longer know who I've loaned to. So, it's absolutely fundamental that I have the right to take my bond or loan back.

AS: What else marks this M&A cycle out from the previous one?

RR: You're seeing more companies divest entire business units, like the industrial company, Finmeccanica, that sold its train business. It's much easier to buy an arm of a company than the whole thing because you negotiate directly with the company rather than with thousands of equity holders under public market laws.

DG: For me, that's where I get the best deals. It's not necessarily the whole company I want to finance. What helps my market is when big companies come together and divisions get sold off. Those divisions won't be eligible to borrow in the public markets, so I have less competition. With the information we also get as a private lender, we are well placed to assess the security of the company.

AS: Thank you. We'll look forward to seeing how investment opportunities across leveraged loans and investment grade credit continue to develop.

This article is for professional clients and should not be relied upon by retail clients.

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In association with

Monitoring change

Andrew Willams explores the impact of M&A activity on the credit market

Summary
- Historically low yields and strong investor demand for credit has created a conducive environment for M&A activity, resulting in higher issuance in the bond and loans market.
- Large M&A deals can have a negative impact on ratings and institutional investors may be subject to rating restrictions.
- Pension funds should ensure their documents offer them suitable protection regarding takeovers, acquisitions and disposals.

New mergers and acquisitions (M&A) activity is at its highest since 2007 - so what are the main impacts on the fixed income and credit markets? And what are the main effects of these impacts on pension funds and institutional investors?

Conducive environment

According to BlackRock fundamental fixed income portfolio manager on the global bond portfolio team, Owen Murfin, the environment is currently "very conducive" to high M&A activity, with historically low yield levels combined with strong investor demand for credit "fuelling the imagination of ambitious CEOs".

"Verizon's record breaking IG deal in September 2013 to fund the partial purchase of Verizon Wireless from Vodafone set new records for the type of deals that could be financed in debt markets," says Murfin.

For Pioneer Investments head of credit research Europe Garrett Walsh, the combination of cash and balance sheet, successful fund raising by private equity and supportive credit markets are all conducive to M&A activity. Given such easy access to capital markets, he suggests that management teams may want to consider acquisitions "as a way to boost earnings for the underlying business by means of exploiting synergies".

"However, synergy targets are usually set quite high and can eventually be missed. The other side of that positive dynamic is rising valuation multiples, leading to over-valuation of targeted companies," he adds.

In Walsh's view, increasing M&A activity represents an additional source of risk for credit markets that "typically causes spread widening". He also points out that higher M&A activity results in higher issuance in the bond and loan market - increasing both supply and the spread compensation required by investors to absorb new issuance.

"The negative impact on spread could be partly mitigated by growing demand from investors who seek higher yields on the investments. Nevertheless, this bid tends to disappear when the market turns negative. As a secondary effect on the market, providers of loan funding usually hedge their exposure via credit default swaps (CDS), and this can ultimately also have an impact on cash spreads," he says.

Global deal-making

With the advent of brand-new borrowers, M&G Investments senior loans manager Fiona Hagdrup also expects issuance to increase in the leveraged loans market - and she highlights the fact that buyout activity by private equity sponsors is linked to "the level of global deal-making of global blue-chip companies".

"Every time a multi-billion merger of corporate titans occurs, there is invariably the need, for competition reasons, usually, for one or two divisions to be sold, creating investment opportunities for sponsors and associated loan issuance for institutional investors. The dry powder in the PE community is significant too, with supportive equity market valuations assisting their typically three to four year business cases for takeover," says Hagdrup.

For her, the change in an investment's risk profile that might result from M&A should be of concern to all investors - and she believes that, although the option to redeem on a takeover event is a natural expectation, it may not always exist in the small print, "particularly in the case of bonds in an investment-grade company being taken over by a riskier concern".

"In the leveraged loans market, the right to be repaid in full upon takeover is one of the central pillars of loan documentation, affording an investor choice in whether to continue to support a newly-transformed company or not," she adds.

Unless funded conservatively, for example with issue of new shares, Walsh warns that large M&A deals usually have a negative impact on ratings. He also stresses that institutional investors may be subject to certain rating restrictions, which could lead to a forced selling of exiting positions.

"Ethical concerns or lower IVA ratings could be the result of an aggressive acquisition, for example when

a new owner of the asset announces significant job cuts. If an institutional investor is subject to ethical investment restrictions, he should be mindful of that. Once the market turns to a more risk-averse stance, liquidity dries up and exiting a position becomes more costly," he adds.

Safeguarding investments

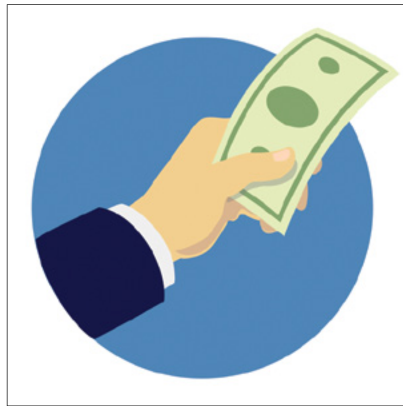
Against this background of increased M&A activity, Hagdrup advises that pension companies, via their asset managers, should ensure that their loan documentation affords them with the correct protections regarding takeover, major acquisitions and disposals, so that they are not powerless in the event of a material change in risk. She also believes that they should be wary of so-called 'cov-lite' loans in small, illiquid deals.

"Maintenance covenants - a series of regular, financial tests with which a company must comply – are an effective mechanism to reprice risk in the event of company underperformance. If they have been forfeited then the ability to sell an investment in the event of such a change remains the only option, so being sure of a ready secondary market is important," she adds.

"Pension companies, via their investment managers, should ensure that their loan documentation affords them with the correct protections"

Hagdrup advises fund investors to ensure they are getting paid for the risk assumed so that the loan stacks up against comparable opportunities, including those in the high yield bond market.

"Know your documentation contains the options and protections that you would expect [and] be assured of your valuation provider, ensure that your portfolio is based on real marks and not fair value assessments in other words," she says.



"Excessive dividend extraction by PE owners before a business has shown itself to have materially improved is usually something to be refused. The substantial rewards for private equity when they have made an operational contribution to a business should be back-ended in our view and made only upon exit when they can prove their alchemy," Hagdrup adds.

Walsh also warns that private equity companies tend to be more aggressive with regards to funding sources of their acquisition targets and points out that the amount of debt they tend to use in the funding mix is "probably around 70 per cent, with the remaining 30 per cent usually consisting of equity-like instruments like shareholders loans and PIK notes, which may also have aggressive terms including the ability to up-stream cash from operating companies".

Walsh also says that companies facing rating restrictions should manage the bucket carefully with low-rated bonds and prefer issuers with a conservative financial policy and bonds with a strong protective language, - including no portability in the change of control, limited flexibility to incur additional debt, an ability to layer in structurally more senior debt and conservative estimates for potential synergies.

"Stay selective and diversified: prefer companies with predictable cash flow that are suitable for leverage. Prefer conservative documentation: avoid portability, minimise the risk of cash leakage and incurrence of additional debt," he says.

"Identify companies with a strong dependence on volume growth [including] those with a high cost base, with a lack of new product pipeline or insufficient geographical diversification - they could find themselves involved in a large M&A transaction, willing to pay high multiples. Valuation of such a company should reflect the likelihood of an M&A deal," Walsh adds.

Meanwhile, Murfin believes that M&A activity is not bad per se as it depends critically on how the deal is financed - with companies using equity or hybrids in combination with debt capable of achieving only a limited impact on their ratings and credit quality.

"At the same time the new asset acquired can in many cases be accretive to earnings and improve geographic diversification. Most of the very large deals within the investment grade space this year have been quite conservatively financed, for example AT&T-Direct TV and Comcast- Time Warner Cable," he says.

"Many companies like Bayer used hybrids as part of the financing package to protect ratings. The fear is that this discipline will drop possibly under pressure from shareholders and as the economic recovery becomes more assured," Murfin adds.

Written by Andrew Williams, a freelance journalist

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