

VIEWPOINT

ISSUE 35

FOR MORE INFORMATION ON SOME OF THESE TOPICS, PLEASE SEE:

- **Credit Market Update**
- **SPECIAL VIEWPOINT: Tips for Troubled Companies**

WHY THIS MATTERS:

Borrowers hoping to refinance in 2009 need to prepare for higher fees, higher interest rates and tighter lending standards.

Companies that can live within their existing capital structure until 2010 will more likely find a loosening of lending terms and a lower cost of capital.

Bank debt is no longer a feasible option for growth capital, so private equity might be an attractive solution for would-be borrowers in this market.

DE-LEVERAGING MEANS TIGHT CREDIT WILL CONTINUE THROUGH YEAR-END 2009

By Jamie Grant

There is a logical explanation for why credit markets are tight and will remain so for the rest of 2009 and into 2010. Banks (and many non-bank lenders) remain overleveraged, and are being forced by regulators and market forces to de-leverage by raising capital and reducing the overall size of their balance sheets. The magnitude of the challenge is as follows: at the end of the last recession, lenders' leverage on Tier 1 Capital was 13.4x. At the end of 2008 many of the largest lenders such as Wells Fargo, Citi, BofA and JPMorgan Chase had total assets in excess of 20x their Tier 1 Capital. As a consequence, lenders must get smaller by lending less, and improve their capital ratios by raising new equity. Until the average leverage for lenders is reduced by 15-30%, the availability of credit for new borrowers will not expand.

For months, we have heard the same lament: "Banks just aren't lending." In reality, banks are lending, but the problem is that most banks are taking in more money than they are lending out – which has prompted congress and business owners to ask incredulously, "with all the TARP money going into banks, why aren't the banks putting it to work?" Here is the answer: banks (and many non-bank lenders) remain overleveraged. This is why the Federal Reserve has determined that several major banks still need to raise more capital.

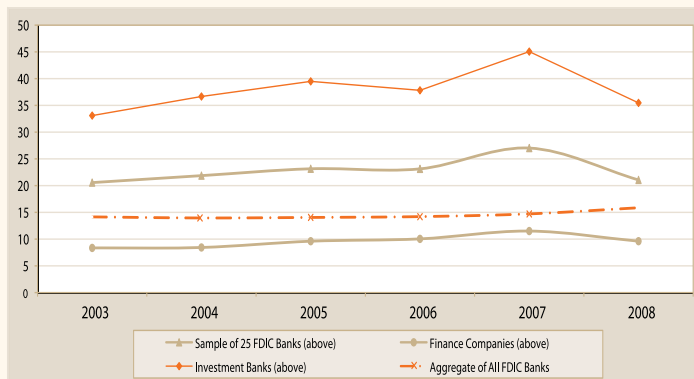
With respect to the state of lending in the current financial crisis, the amount of debt capital in the market at the end of Q4 2008 represents the high point, and for the foreseeable future, it appears there will be less lending, not more.

The grim reality is that lender balance sheets are of necessity getting smaller, and will continue to do so throughout 2009. Concerns about unrecognized loan losses from home mortgages and rising default rates on commercial real estate and business

loans prompted the Federal Reserve in February to run the much touted stress tests to audit the capital adequacy of the nation's largest bank holding companies. It is becoming clear that until lenders (including FDIC-insured banks, finance companies and investment banks) have reduced their leverage on Tier 1 Capital by 15% to 30% relative to where they were at the beginning of this crisis, the aggregate value of debt in the market will continue to decline. "Tier 1 Capital", the value of the lender's equity less goodwill and intangibles, represents the capacity of a lender to absorb losses. According to Q1 filings, the largest banks are nearly half-way there.

Figure 1 illustrates the increase in leverage on lenders' Tier 1 Capital through 2007 and the subsequent decline in 2008, most of which took place in the three quarters following the Bear Stearns failure. The aggregate leverage for all FDIC-insured lenders taken as a whole peaked in Q4 2008, despite the fact that the biggest national names in banking, investment banking and finance companies began de-leveraging earlier in the year.

Fig. 1 The Rise and Fall of Lender Leverage
Multiple of Total Assets on Tier 1 Capital from 2003 to 2008



Sources: CapitalIQ, Company Filings, FDIC Quarterly Banking Profiles

IN PURSUIT OF PROFIT... PROFLIGACY.

From 2003 through 2007, regulatory capital adequacy standards for lenders remained unchanged while the glut of new capital in the marketplace drove down interest rates. In order to grow their earnings and maintain a positive return on assets, lenders were forced to increase their Tier 1 leverage. This meant that the lender had to either increase the size of the loan portfolio without raising new equity capital (which would have been dilutive to earnings per share), or increase yields by taking on riskier loans. These objectives were achieved in many ways, some of which have been written about extensively such as the securitization of loan portfolios (CLOs, CDOs, etc.). However, leverage was also achieved using more customary measures such as raising deposits as well as the use of warehouse lines, and the issuance of commercial paper and corporate bonds.

Ironically, though not surprisingly, more debt issuance by banks, finance companies and investment bankers resulted

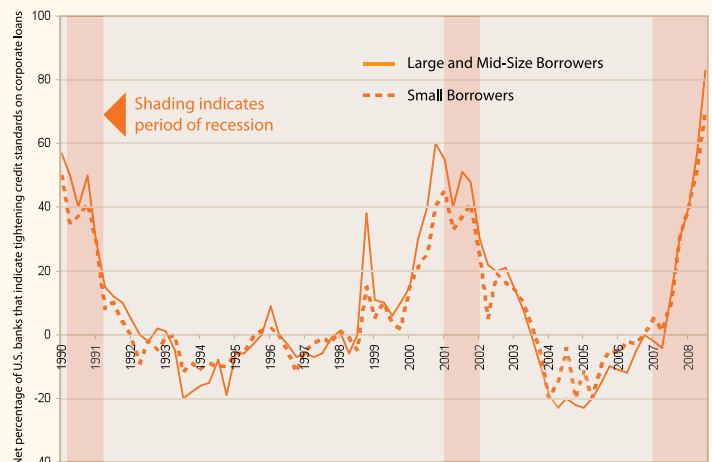
in more capital in the market for commercial and residential borrowers. As a consequence, borrowers took advantage of looser credit standards and low rates to finance everything from capital expenses to operating losses. Credit became so easy to obtain that retailers, automotive dealerships and service firms with no lending experience or infrastructure began offering credit directly to their customers, acting as loan originators for finance companies and banks.

By the end of 2007, the investment bank of Merrill Lynch was operating with leverage on Tier 1 Capital of more than 38x, and Citigroup's had grown to 44x. Not to be outdone, European investment banks such as Barclays and UBS had leveraged their balance sheets to 80x and 104x respectively. But on March 16, 2008 the lending world got a wake-up call. Bear Stearns, which was levered 36:1 and highly dependent on the availability of short-term (i.e. overnight) debt financing, suddenly discovered the music had stopped and there was a chair missing. The Federal Reserve believed at that time that by orchestrating the salvage of Bear Stearns by JPMorgan Chase, the market could avoid the sort of calamity that came later with Lehman Bros. It also hoped that the near death experience would signal to the rest of Wall Street that financing loans of cash and securities to clients with a toxic mix of high leverage and short-term maturities was not a winning strategy.

NOW WHERE DID I LEAVE THAT FIRE EXTINGUISHER?

In the wake of the Bear Stearns collapse, lenders tightened credit standards immediately and aggressively, as illustrated in Figure 2 below. However, the horse was already out of the barn. We later learned that the recession had begun at the end of 2007, and unlike the recent recessions of 1990-91 and 2001-2002 where banks tightened credit ahead of the downturn, this time they had waited too long. Despite their efforts to reduce exposure by lending less during the last three quarters of 2008, the massive amount of credit extended to borrowers in 2005, 2006 and 2007 would ultimately require that lenders raise new equity capital or face insolvency.

Fig. 2 Credit Tightening Trends Since 1990
Measures Lenders' Tightening or Loosening of Credit Standards



Source: Federal Reserve (published in the Wall Street Journal, November 4, 2008)

"It is becoming clear that until lenders have reduced their leverage on Tier 1 Capital by 15% to 30% relative to where they were at the beginning of this crisis, the aggregate value of debt in the market will continue to decline."

The AIG and Lehman filings were variations on the Bear Stearns theme. An over-reliance on short-term borrowing and hypothecation to support their operations made it impossible for these firms to absorb significant losses. Once the losses became evident to creditors, it became clear that neither firm had sufficient capital to cover their obligations. Suddenly in September of 2008, Wall Street was on fire.

Whether or not the Lehman bankruptcy should have been avoided will be debated for years to come, but the underlying reality of the financial system at that moment was that it was overleveraged and hopelessly dependent on investor confidence, with asset impairment making matters worse in a hurry. Direct investment into financial institutions was the only solution to reduce leverage and avoid widespread insolvencies. Seeing no other investors willing to fill that void, the Bush administration, and later the Obama administration, showed up with their fire extinguishers (full of U.S. taxpayer dollars).

SO WHERE DO WE GO FROM HERE?

At the end of Q3 2002, immediately following the last recession, the leverage on Tier 1 Capital for FDIC banks stood at 13.4x. We believe that for the lenders that remain in the market, leverage will likely return to a range of 13.0 to 13.5x before investor confidence returns and balance sheets begin to expand again. However, "average" leverage for the banks only tells one part of the story. A significant number of lenders have exited the market or been acquired due to inadequate capital. The capital once provided by Lehman Brothers, Textron Financial, Washington Mutual and others won't be coming back, and although Merrill, Bear, Goldman, and Morgan Stanley live on, their balance sheets will have to contract significantly to meet with FDIC capital adequacy requirements for bank holding companies.

At the end of 2008, leverage was 15.9x for all FDIC banks, 21.1x for the larger bank holding companies (listed in Figure 3), 35.5x for investment banks, and 9.6x for finance companies. Based on the Q1 filings available for this analysis (again, see Figure 3), the large banks reduced leverage by 15% in the first quarter to 17.9x. As an industry, banks will need to trim their balance sheets further by approximately 15% to reduce

Tier 1 leverage to the 13.4x that followed the last recession. Investment banks that have been acquired by or converted to bank holding companies will need to de-leverage by 62% on average. In the case of the finance companies, their challenges are not with capital adequacy so much as access to capital in the form of warehouse lines, commercial paper, and loan securitization. Finance companies such as GE Capital, GMAC and Newstar have had to find new sources of capital (deposits), and some, most notably Textron, have had to exit the business altogether.

QUESTIONABLE PRIORITIES

In the past several weeks, Bank of America, Citigroup, Morgan Stanley, Wells Fargo and Regions Bank have all raised new capital – totaling over \$50 billion in new equity capital for the financial industry this quarter. This new capital, if used to bolster the issuer's balance sheet, might reduce leverage to a degree that these banks will once again be positioned to expand. However, several of the firms raising private capital, including Goldman Sachs, Morgan Stanley, and JPMorgan have formally asked the Federal Reserve to allow them to pay back the billions of dollars that they borrowed under the TARP. Rather than reducing leverage, these firms are looking to get out from under the increasingly troublesome restrictions being imposed on TARP recipients, which does nothing to improve the availability of credit.

I recently asked a panel of asset-based lenders at a TMA event to opine on whether they believed the current trend of de-leveraging would continue, and if so, for how long? Not surprisingly, most lenders don't want to answer this question (so I won't name names). The head of Business Credit for one of the largest banks receiving TARP funds was brave enough to offer this honest assessment: "I think that this [de-leveraging] trend has to continue in the short term, and probably through the end of 2009."



Jamie Grant is a partner at Mirus Capital Advisors, Inc. Founded in 1987, Mirus Capital Advisors is a middle-market investment bank that specializes in merger advisory, capital-raising services, fairness opinions and valuations to entrepreneurs, corporations and professional investors. By combining a proven process, industry and transactional expertise, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Our affiliate Mirus Securities, Inc. is a registered broker-dealer and FINRA/SIPC member. Additional information about the firm is available on our website www.merger.com.

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