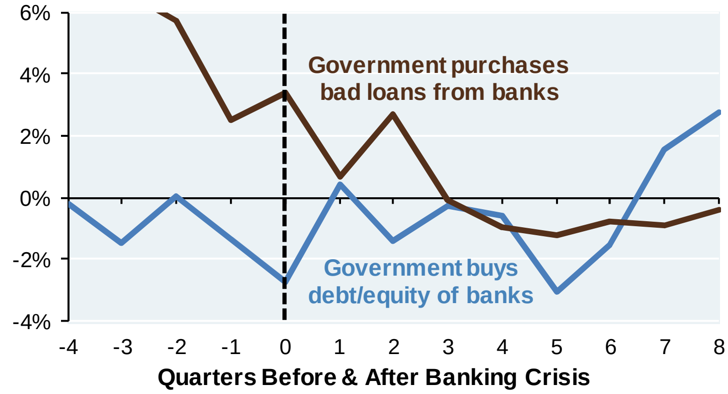
What happens when countries and companies have to go for Plan C; we prefer the latter to the former as an investment

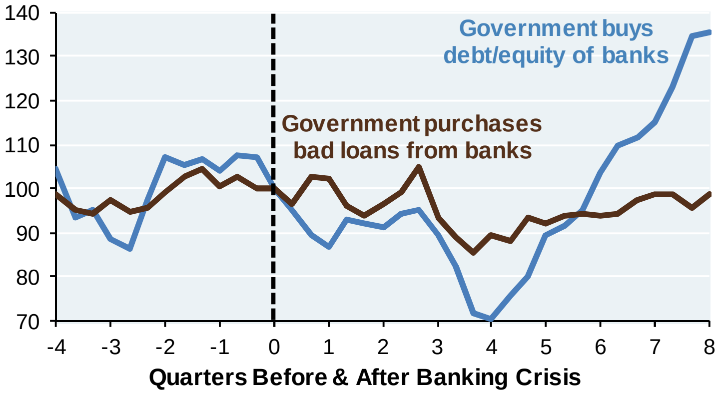
On to Plan C. In Spain, Plan A was the 2010 announcement of government austerity targets. Plan B was the 2011/2012 ECB lending program to Spanish banks, to the point where Spanish banks now own 50%+ of Spanish government debt. Neither plan worked in terms of stabilizing Spanish government bond yields, which rose towards 7% last week. So on to Plan C, the forced recapitalization of Spanish banks we guessed at in last week's note, financed via a ~100 billion Euro loan from the EU bailout fund to the Spanish government. The purpose: allow banks to absorb the avalanche of losses that may lie ahead.

This step has been very good news in the past. In October 2008 when TARP was debated in the US, we published the two charts below. They're based on IMF data from the last century of banking crises, and indicate that **countries that recapitalized their banks, rather than just buying up their bad loans[1], experienced faster recoveries in growth and in equity markets.** This process appears now to be underway in Europe. The devil is in the details: parliamentary approvals; the knock-on effect of another 100 bn in Spanish debt, pushing it closer to 90% of GDP; and how bank losses are shared between bondholders, shareholders and the government. But overall, this step reflects the recognition that Spain faces a deep solvency crisis and not just a liquidity crisis, and is better news than the announcement of a third ECB lending operation to Spanish banks.

Economic recovery faster when the government purchases equity/debt, Real GDP growth rate, YoY change



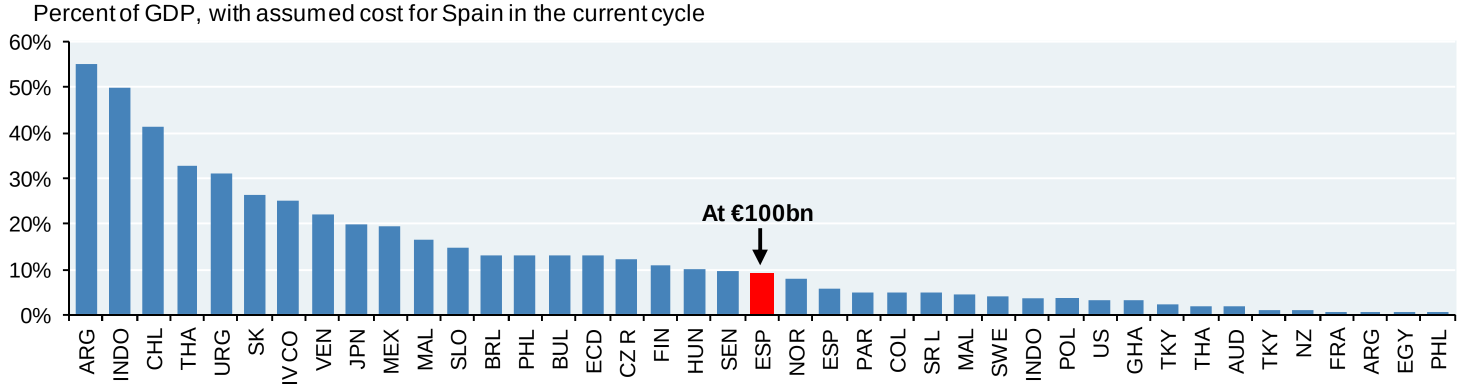
Stock market recovery faster when the government purchases equity/debt, Average equity market performance



Source: *"Symmetric Banking Crises: A New Database"*, IMF Working Paper WP/08/224, Laeven and Valencia, 2008. As referenced by Francios Trahan.

While I don't want to overthink it, I wonder whether 100 billion is enough. In the context of the last 20 years of banking crises, it would rank in the middle (see chart). Given conditions in Spain, it might need to be higher (at least it's not the 40 billion rumored to have been recommended by the IMF). Other reservations include the implied **subordination** of government bondholders, since the EU presumably sees itself as a preferred lender to the Spanish government. Spain's private sector is still in tough shape, so Spain may still have to opt for a sovereign rescue package in excess of 300 billion this year or next. In any case, this latest step definitely **reduces banking sector risks**, but does not otherwise change the cautious view we have given low growth, inter-regional capital flight and rising debt burdens across the Periphery. **The primary benefit of the Spanish bank recap may be reduced financial sector contagion risk to Asia and the US; we'll take it.**

Fiscal cost of banking crises, 1980-2000
Percent of GDP, with assumed cost for Spain in the current cycle



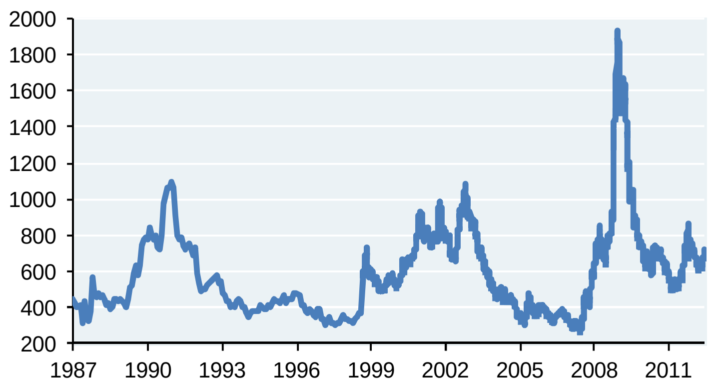
Source: World Bank, Haver Analytics, J.P. Morgan Asset Management.

[1] The ECB hasn't even been buying up bad loans in Spain and Italy, it has simply been lending against them, which is why they did not have a durable beneficial impact on market perceptions of banking sector or sovereign risks.

What happens when countries and companies have to go for Plan C; we prefer the latter to the former as an investment

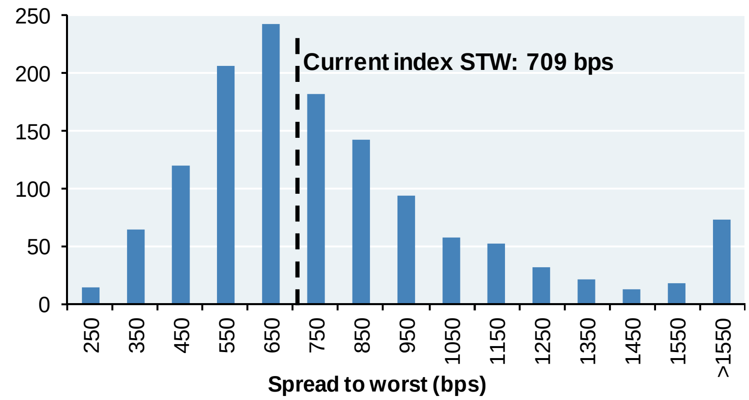
<u>What happens to non-investment grade companies when they also have to opt for Plan C</u>
For most non-investment grade companies, borrowing from banks and public bond markets are Plans A and B. Bank loans are often cheaper, but are shorter-term and more covenant-intensive. After high yield bond spreads quintupled during the recession, they have since rallied back sharply, as shown in the first chart. This is just an index, however; there is a wide range of spreads in the high yield markets, as shown in the second chart. This range reflects the wide dispersion of credit ratings, debt service coverage, the timing of maturing debt, sector risks, etc. among high yield borrowers.

US high yield spreads
Spread to worst, basis points



Source: J.P. Morgan Securities LLC.

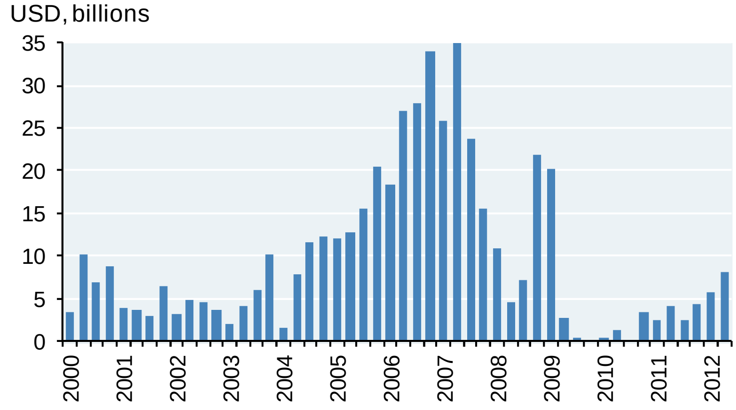
J.P. Morgan US high yield index
Spread to worst, number of companies



Source: J.P. Morgan Securities LLC. Data as of June 06, 2012.

What these charts obscure, however, is what kind of companies have *access* to high yield bond markets and bank debt. As shown in the chart below, one driver of demand was collateralized loan obligations, which is a shadow of its former self even with a recovery in 2011. In addition, new rules have resulted in a sharp decline in primary dealer positions and proprietary trading desks, another source of demand (see Appendix). As a result, many small and medium-sized companies no longer have easy access to public credit markets. That trend is shown in the second chart on debt issuance by companies with less than $50 million in operating cash flow. **What do these companies do? They are forced to consider Plan C: private credit markets.**

US CLO quarterly gross issuance
USD, billions



Source: J.P. Morgan Securities LLC.

Debt issuance by mid-market firms (EBITDA <=$50mm)
Number of deals, quarterly

Source: Standard & Poor's LCD.

Sometimes referred to as "mezzanine lending", private lending refers to provision of credit to companies that for a variety of reasons do not have easy access to bank or public credit markets for all or part of what they need. Since 2009, we have focused on private lending since spreads and terms are attractive relative to conditions which prevailed from 2004 to early 2008 (See EoTM 5/23/11, 1/1/12 and 1/11/12). In these notes, we discussed the characteristics of private lending opportunities we have seen in the market: substantial equity subordination of 30%-40% below mezzanine debt; cash coupons of 10%-12%; additional potential returns since debt is often issued at a discount to Par; and pro-forma debt service coverage of 2.4x-2.7x.

However, these were the terms available to "better" high yield companies who rely on private credit markets for a small fraction of their total debt. What about companies that have bigger problems and challenges, that like Spain, are forced to seek out rescue or growth financing from other sources? The following section outlines some of the opportunities we have seen in "rescue financing markets", a euphemism for companies that have to resort to a Plan C of their own.

What happens when countries and companies have to go for Plan C; we prefer the latter to the former as an investment

Example I: a small company experiences a sharp decline in revenues and faces a pending maturity

A manufacturer and retailer of vehicle parts and accessories hit the skids (sorry) in 2009. Even though it maintained a leading market share position, the company's cash flow fell by a third in 2009 as industry unit sales fell by twice that amount. Cash flow recovered modestly in 2010 and coverage of interest was almost 3.0x, but the syndicate of issuers holding the company's senior debt wanted out as 2012 and 2013 maturities loomed. As shown below, a new capital structure was put in place which repaid senior lenders; subordinated the former holders of the company's mezzanine debt; required mezzanine debt holders to have their coupons accrued and not paid if cash flow targets are not met; required an additional junior capital contribution from the company's owners; and financed the acquisition of an online retailer. The debt service coverage through the "second-out tranche", which is the kind of private lending opportunity we are looking at (see red dotted box below), is 2.1x, and the ratio of debt to cash flow is around 4.5x. Post-restructuring, the company is able to compete and see what it can do without the overhang of its maturing senior debt. If it doesn't work out as well as planned, private lenders have substantial protection in the form of subordinated capital providers who would suffer first.

Before	After
165mm senior debt due in less than 1 year Libor + 5.5% (with a 2.5% Libor floor) Debt service coverage of 2.7x	**170mm senior secured loan due in 6 years (2 tranches)** 4.4x leverage and 2.1x debt service coverage through senior loan
73mm operating company mezzanine debt at 11.3% 6.9x leverage through mezzanine debt Debt service coverage through mezzanine in 2007: 1.7x	→ **45mm first-out tranche** Libor + 5.3% (with a 2.5% Libor floor), 1% Original Issue Discount No call protection, no warrants
72mm holding company notes (subordinated to operating company debt) with an 18% non-cash coupon	→ **125mm second-out tranche** Libor + 10.2% (2.5% Libor floor), 2.4% Original Issue Discount 3 years of call protection, Warrants for 5% of co. struck at 1¢ 13.1% Yield to Maturity, 14.8% Yield to Call
Problems 1. Pending debt maturity 2. Sharp earnings decline during recession 3. Small capitalization issuer	100mm operating company mezzanine (carryover of existing 73mm plus 27mm new mezzanine from sponsor) 6.8x leverage and 1.3x debt service coverage through mezzanine debt
	37mm of holding company notes reinstated at 4% non-cash coupon and the rest were converted to equity

Example II: An unknown issuer needs capital, and doesn't make it appealing enough for banks

Sometimes part of the challenge for an issuer can be a lack of name recognition. During the credit boom, that usually wasn't a problem, but it can be today. A diversified company in the Pacific Northwest owns the royalty stream in one of the largest zinc mines in the world, provides management and operations services to oil and mining companies in the region, and owns/operates hospitality and tourism properties. It sought to raise money to finance an acquisition, and to retire senior debt at the company it was acquiring. However, the company had no issuance history or market name recognition.

At first, the company's bankers committed its balance sheet to help, and attempted a syndication of a secured bank loan at Libor plus 5%. However, these efforts were unsuccessful, and the bank ended up providing very expensive bridge financing at 10% until a better solution could be found. Private lenders were contacted to see if they were interested, and pointed out that the collateral package (which included the zinc mine interests) was problematic in one key aspect: it was located at the company's parent company, instead of at the legal entity that was borrowing the money. Private lenders insisted that the parent company deposit the royalty stream into a control account for the benefit of lenders to the borrowing entity itself.

As shown below, private lenders put together a financing package that included a first lien and a second lien. The first lien was sold to traditional buyers (banks and CLOs), and private lenders retained the second lien, which provided a higher spread. In addition to the improved collateral package, the structure provides call protection for the new lenders, and covenants which require leverage to decline from 4.3x cash flow to 2.6x by the end of 2013. An original issue discount of 8% adds to the potential returns for the private lenders ("OID" in this case refers to lenders providing less than Par to borrowers, but still requiring Par as a basis for interest and principal repayment). As in Example I, a Libor floor is used to protect lenders by computing interest as if Libor were 1.5% (in Example I, the Libor floor was 2.5%). I am hoping that 3-month Libor, which is now 0.46%, rises above 2% at some point over the next decade.

What happens when countries and companies have to go for Plan C; we prefer the latter to the former as an investment

Before	After
43.3mm mortgage debt & capital leases No other senior secured or unsecured debt **Problems** 1. No issuance history or market recognition 2. Collateral package pledged to parent instead of borrowing entity 3. Too aggressive on issuance terms: Libor+5%; Libor floor 1.5%	**225mm first lien debt; 1.6x leverage** 6.5mm Asset Backed Lending revolver at Libor+2.75% 43.3mm mortgage debt & capital leases 175mm first lien term loan; 5 years, Libor+5% Libor floor 1.5%, 2% Original Issue Discount **260mm second lien debt; 3.6x leverage** 5.25 years, Libor+8.75%, Libor floor 1.5% 8% Original Issue Discount, 1 year of call protection No warrants, 14% Yield to Maturity, 23% Yield to Call 3.1x debt service coverage ratio through the second lien

Example III: An overleveraged industrial company needs room to breathe

A company that manufactures steel and metals products for oilfield and other industrial operations benefits from a 25% market share, the largest in the industry. However, a combination of declining steel prices and a dramatic reduction in oilfield steel demand due to sharply lower capital budgets resulted in an over-leveraged balance sheet, which ended up impairing its relationships with suppliers and affecting its normal business operations. Revenues declined by 28% in 2009, and its debt to cash flow leverage rose above 10x. When revenues began to rise again in 2010, the company was looking for a way out: a new financing package that was more reliant on equity rather than debt, given the inherent cyclicality of its business, and which would restore its credit profile in the eyes of its suppliers.

Private lenders don't always just lend: sometimes they provide preferred equity as well. In this case, a private lending firm believed that the company has attractive growth potential, in part a reflection of increasing demand for metals products from natural gas fracking companies. The company was restructured in a way that sharply reduced its reliance on senior debt, and eliminated the equity held by previous senior lenders, a by-product of a prior restructuring. The preferred equity holders effectively acquired the company at 5 times cash flow (an attractive multiple to other comparable transactions), and the new capital structure allowed the company to immediately obtain greater flexibility and better terms when sourcing steel and other raw materials. The common equity holders still exist in principle, but have seen their economic interest substantially diluted by the terms and conditions of the preferred equity.

Before	After
Capital structure after the first restructuring 146mm first lien loan with lenders receiving 33% of company through warrants 37mm second lien loan with lenders receving 8% of company through warrants Peak leverage of 10x through second lien **Problems:** 1. Covenants excessively restricted normal operations 2. Low credit profile impairs supplier relationships 3. Highly cyclical business	**New financing package: 225mm due in 5 years** → 47mm Asset Backed Lending revolver at Libor + 2.5% → 20mm term loan at 8% → **157mm preferred equity** 11.5% dividend paid in-kind plus 20-40% of all distributions upon sale of company, depending on timing and multiple of invested capital received upon sale Leverage through senior debt: 1.6x operating cash flow Leverage through preferred equity: 5.3x operating cash flow

The balance sheet rental example. Other instances of private lending include situations where large cap companies choose to make acquisitions or finance their operations without using parent company balance sheets. For example, suppose additional parent company financing would lead to a downgrade, given existing levels of debt. A parent company making an acquisition might "rent" expensive capital in a non-recourse, collateralized fashion which provides lenders with substantial asset coverage and high pro-forma returns. Despite the high cost of the *incremental* debt, the parent company preserves its credit rating, and avoids a downgrade of the company's *entire* capital structure which could be even more costly.

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The idea behind private lending is that someday, if all goes well, the borrowing company can migrate back to more traditional Plan A or Plan B bank or debt markets. In each of the cases above, that's the expectation: the rescue is a temporary one lasting a few years (or less), without quasi-permanent commitments of capital.

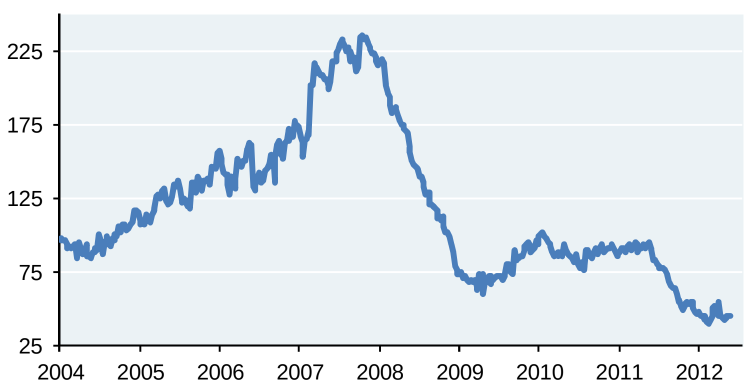
I hosted a lunch last week for CIOs of endowments, foundations, pension plans and insurance companies. In addition to the problems in Europe, attendees expressed deep concerns about how to meet payout targets at a time of low interest rates. One of the consequences of today's interest rate environment is that **a lot of investment funds commit to an annual payout rate of around 5%, which is 4.5% over Libor. Until 2001, a 5% payout rate was generally *below* Libor. This shift is one of the most remarkable changes in US capital markets in many decades, and has significant implications for any CIO or high net worth investor seeking to match investments and payouts with an acceptable level of portfolio risk.** There are no magic-bullet answers to this conundrum, but mezzanine lending and rescue lending can in our view play a partial role in a broader portfolio. To wrap up, private lenders generally take steps to *increase* the subordination beneath them, while events in Europe are further subordinating holders of Spanish government bonds. We'll take our chances in the corporate sector.

Michael Cembalest
J.P. Morgan Asset Management

Extra charts of the week

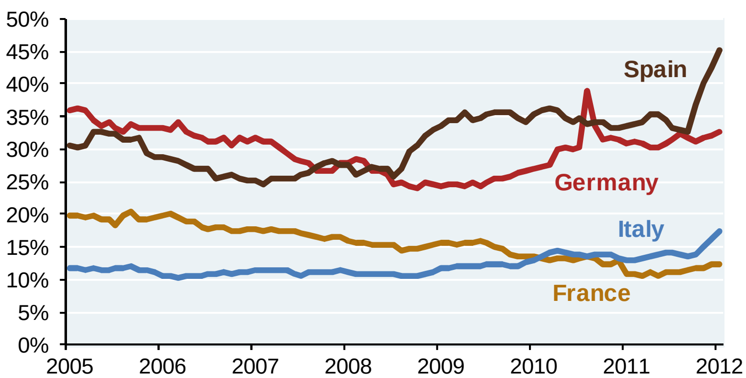
The decline in US primary dealer corporate bond positions, a partial reason for higher spreads in private lending markets; and the increasingly symbiotic relationship between Spanish banks and the Spanish government

Primary dealer corporate bond positions
Billions, USD



Source: Federal Reserve.

Domestic bank lending to central governments
Percent of total government debt owned by banks



Source: Bundesbank, Banque de France, Banca d'Italia, Banco de Espana.

ECB	European Central Bank	TARP	Troubled Asset Relief Program
IMF	International Monetary Fund	CLO	Collateralized loan obligation
EBITDA	Earnings before interest, taxes, depreciation and amortization (what we refer to as "operating cash flow" above)		

"*Controlling the Fiscal Costs of Banking Crises*", World Bank Policy Research Working Paper 2441, Honohan and Klingebiel, May 2000.