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Elements of Corporate Risk (Second of a Series)

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It’s hard to believe, but this July marks the ten-year anniversary of the collapse of Bear Stearns’ two sub-prime hedge funds, the first of a succession of events that eventually culminated in the worst economic downturn in the US since the Great Depression.

While the recovery since has been anything but robust, the more the Great Recession recedes in dealmakers’ memories, the more challenging it is to recall what happens when credit markets seize up. Despite the seeming boost of confidence the new administration has provided for US companies, the rule of business cycles still holds.

Cyclicality – For experienced asset managers, it’s no stretch to suggest that corporate risk is divided between companies that are cyclical, and those that aren’t. Or more accurately, those that are cycle-correlated and those that are cycle-resistant. The trick, of course, is to know which borrowers fit into which categories.

It’s helpful to have historic numbers for the borrower through the 2007-09 period, but that’s increasingly rare. Even when revenues are available, the refrain often heard from selling bankers is, “That was ten years ago. It was a different company then.”

Knowing how sensitive an issuer’s top-line is to GDP is taking on increasing importance today as both sponsors and lenders are pushing the leverage envelope. Our shop always runs a harsh down-side case that simulates a recession in the next year or two. How well the company is then able to demonstrate reasonable leverage and coverage ratios, is a good measure of how comfortable a lender should be with the proposed debt burden.

Sectors such as chemicals, heavy manufacturing, autos, and home construction tend to hew closely to the business cycle, whereas business software, value-oriented consumer products, and healthcare are more defensive in nature. Lenders that over-lever borrowers in the former group, assuming the next recession has been pushed off indefinitely, may find themselves hip-deep in trouble when a downturn comes.

Specialized sector knowledge – Lending in certain industries demands more specialized knowledge than most traditional middle market sectors such as business services, manufacturing, and distribution. Broadly syndicated loan managers often have analysts covering aerospace, gaming, mining and metals, restaurants and retail, high tech, and financial services.

These sectors are comprised of large, public companies who are frequent issuers in both the loan and bond markets. For large cap managers, understanding the credit nuances of industry leaders is critical. PMs can trade in or out of an asset based on earnings news and industry developments to protect their portfolio.

But for direct lenders whose loans are smaller, private, and illiquid, dabbling in sectors that demand specialty expertise is risky business.

Next week we discuss the three most common corporate risk elements