What’s Leverage Got To Do With It? A Response

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It was unavoidable, we suppose, that a retired senior bank credit officer would be compelled to respond to our previous column. High debt-to-ebitda leverage, we asserted, was misleading and should be viewed in context of other considerations.

Though preferring anonymity, this self-described “credit dinosaur” has been known to us for decades as an experienced participant in, and keen observer of, the middle market. He is also an avid follower of (and, full disclosure, a paid subscriber to) this newsletter. We thus feel obliged, for the benefit of our readers, to share his insights on leverage.

We had observed last week that an important factor was to also analyze how much equity a sponsor was investing relative to the overall capital structure. Our worthy Riskosaurus pointed out that isn’t necessarily a mitigant to increased leverage.

“If private equity firms pay ridiculous purchase price multiples,” he declared, “then one would expect them to shoulder the entire burden via increased contributed equity.” In that case, he argued, leverage as measured by debt to cash flow should stay constant.
If leverage goes up, then sponsors are “unreasonably leaning on lenders to share a portion of that burden.”

The next bone of contention was that certain industries deserve more leverage favor than others. The Creditactyl agreed with the basic premise, and that averages are deceptive (“On average, having one foot in a bucket of ice water and another in a bucket of boiling water isn’t good”). But he doubted the software sector necessarily merited higher leverage (“A better software mousetrap always lurks around the corner.”)

We meant business service companies with dominant market share and recurring revenue models (e.g. transaction processors such as*SourceHOV*), but point well taken.

On the subject of Ebitda size, he concurred that larger issuers may gain greater access to capital markets, thus affording more financial flexibility than middle market companies. But that does not necessarily translate to more business resilience.

Specifically, he noted that in times of financial stress, a large cap borrower with forty lenders among various tranches will be more challenged to manage that group than a smaller company with four lenders in a simple capital structure.

Finally, he disputed as “wishful thinking” our view that issuers that are projected to de-lever quickly can withstand more debt. “The fact is,” he said, “those high free-cash-flow companies are the first ones sponsors recap in good times, leaving them strapped in the downturn.” For this venerable Tricashatops, de-levering generally occurs “only in creative bankers’ imaginations.”

What comes across clearly in this well-considered response is how credit considerations go beyond statistics. For experienced risk managers, it’s not just about making smart decisions. It’s about resisting the temptation to follow the crowd over the cliff.