Corporate debt markets find themselves in arrears

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A year ago, the Bank of England published a report discussing the similarities between the subprime mortgage market and the so-called leverage finance market, in which private equity firms raise capital to fund the purchase of target companies. The bank identified signs of deterioration in the mortgage market and concluded that such episodes "could provide a warning of corporate stress to come".

Today, that assessment looks prophetic. On the face of it, the factors that prompt a homeowner in Florida to default on a mortgage seem quite distinct from the pressures that might spell trouble for private equity groups such as Apollo Management and TPG in financing their buy-out of Harrah's Entertainment, a gaming company in Nevada.

However, as the Bank of England observed, what the US mortgage market and corporate debt world have in common is that lending standards have crumbled in recent years - partly because banks have been repackaging this debt and selling it on to outside investors.

Consequently, there are now rising fears that problems that have already unfolded in relation to mortgages could be replayed in the corporate debt world, with potentially painful implications for growth.

"Since the first subprime scare nearly a year ago, credit conditions have tightened for all types of loans," note economists at Goldman Sachs in a recent report. "The impact of tighter credit conditions could directly subtract 1¼ percentage points from first-quarter growth and 2½ points from second-quarter growth."

Part of the problem is that the investors who have been financing mortgages in recent years have often been the same group financing big buy-outs. These have both been driven by the same desperate need for yield - meaning that credit risks have been increasingly overlooked. "There is so much liquidity in the world financial system that lenders are making very risky credit decisions," wrote Bill Conway, co-founder of Carlyle Group in a letter to his partners just over a year ago. "This debt has enabled us to do transactions that were previously unimaginable."

Another reason for parallels between mortgage and corporate debt is that both asset classes have become sucked into a relatively new kind of financial engineering machine this decade, which has typically been taking up to 200 individual loans or bonds, slicing them and then creating new debt parcels, subdivided according to risk.

Many of the securities that emerge at the end of this complex "slicing and dicing" chain are ultra sensitive to market movements - meaning that even a small move in price can involve huge losses. Or, as the Bank noted last year: "The embedded leverage [in these instruments] . . . could magnify the market response if there was a particularly sharp deterioration in the performance of underlying assets."

This meant that when losses started to emerge in the mortgage world last year, many investors panicked - and then pulled out of corporate debt as well. That, in turn, has created a supply-demand mismatch. Data from TPG, for example, suggests that there was six times more buy-out debt available in the summer of 2007 than there was in 2006.

As a result, the price of corporate debt has plunged - particularly for debt deals concluded over the past year. Today, the banks financing the big deals still in the works, such as the buy-outs of Clear Channel Communication and BCE, are looking at huge losses. Indeed, at least one bank in the underwriting group has already written Clear Channel down to 85 cents on the dollar.

Some investment bankers hope that if prices fall further - say to 80 cents on the dollar - more buyers will come into the market again. And they are doing their best to attract skittish purchasers. Recent deals have had so-called Libor floors, which made the new loans less vulnerable to rate cuts. Today, private equity firms wanting to buy companies have begun writing equity checks for the whole thing, reasoning that they can eventually go to the debt market to refinance, according to Doug Warner, a lawyer at Weil Gotshal & Manges in New York.

But the main ghost haunting the market is the uncertainty about the economy. If the economy really slows dramatically, corporate cash flows will dry up. Then, companies with heavy debt burdens will find it even harder to pay their debt - creating even more trouble ahead.

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