IS THIS THE SUMMER OF 2007?

The Transcript below is taken from a July 2014 interview by John Slater, Publisher of Capital Matters, with Randy Schwimmer, Publisher of The Lead Left. You can access the full interview and a related article at http://capmatters.com/wp/is-this-the-summer-of-2007/.

John Slater: Good Afternoon, I'm John Slater and this is Capital Matters. Today we have with us Randy Schwimmer. Randy is one of the pioneers in the middle market leveraged lending and loan syndication industry. He has recently started a new publication called The Lead Left, which I view as the most informative publication covering what's going on in the private loan markets. Randy has unique insight because of his experience, which includes stints at big banks as well as with leading private equity groups where he was active in originating leveraged loan transactions.

Good afternoon, Randy.

Randy: John it's great to be with you. Thank you for having me.

John: So it may be best to start briefly with background on yourself and on The Lead Left

Randy: That would be great. As you mentioned, I've been doing this for a while and being a pioneer, or I guess, being called a pioneer means I've been doing it for a long time. I actually started in banking at the old Chase Manhattan Bank back in the mid 1980's. In those days, a middle market loan was something that was kept and held by one bank and there was very little trading amongst banks.

What happened was [that] as deals got bigger, banks had to figure out ways of sharing risk. In those days, what people like me would do was call our friends at other banks and say, "Hey, we've got a $100 million dollar loan. Would you like to come in for 20?" Partner that up with five of your best friends and all of a sudden you've syndicated a loan even though you didn't know that's what you were doing.

The syndication market developed in the middle market that way just by creating a club group of lenders, and in some ways, almost thirty years later, it really hasn't changed that much. There still is a club group of banks who focus on the middle market. A lot of other things have changed, but that core principle is pretty much the same.

I spent half of my career on the so-called 'sell-side' with Chase which became JP Morgan and then moved to BNP Paribas, running their middle market leveraged syndication desk. And then, in 2007, I started a firm, with five other partners, called Churchill Financial, which was a 'buy-side' shop. It was about at that time John that I started a publicly distributed newsletter called On the Left, which some of your readers may remember. We distributed that to our Private Equity clients. We started doing it a year and a half after we started Churchill – in the 2008 timeframe, just after the credit crisis began to show its ugly signs in 2007. We thought it would be good to show clients what was going on, give them a little more transparency from the market.

I started the newsletter, initially, as an internal publication. That leaked out to one of the clients and they said they wanted to send it to all of their partners. It grew to a point where we had somewhere between thirty to thirty-five thousand subscribers to that newsletter. We took it with us to The Carlyle Group when Churchill was acquired in November of 2011 and kept that going until Carlyle went public the following spring. They were concerned about the Company hanging out there with a lot of public emails and so, we decided at that point to put it on hiatus.

I since, over the last several months, have left Carlyle to, among other things, restart the newsletter, now calling it The Lead Left. By the way, it's not a political term, John, it's investment banking speak for anyone who actually leads a syndicated deal. The term comes from the old days, you remember, when the tombstones were regularly published in the Wall Street Journal. They would put the lead bond underwriters on the left and the syndicate members on the right.

So, that's what I've been doing the past several months – restarting that effort – and it's been an interesting time to be publishing. As you know, there are a lot of interesting things going on.

John: So, in the time that you've been involved in the market, would it be fair to say that the development of this market has been a critical component to the growth of the Private Equity industry overall?

Randy: Absolutely. It's a little bit of a pyramid when you think of the number of companies that are middle market companies versus large cap companies. The same is true of private equity groups as well. At the top, you've got a few large firms: Carlyle and the other big private equity firms and below that you've got a significant number of smaller private equity firms investing in middle market companies. There have been some studies done that show that most of the growth for small companies has come from private equity investments. That's a whole other interview we can do, but the bottom line is that a lot of the growth hasn't come from the Fortune 1000. Smaller companies tend to be more entrepreneurial, tend to be more growth oriented, and PE sponsors, who are investing their capital more and more, are discovering that smaller companies are more attractive. And so, a lot of capital has been diverted to the middle market.

John: Randy, when you started, this market was a few billion dollars a year. By the time it peaked in the 2006-2007 timeframe, it was hundreds of billions of dollars a year. Obviously, it went through a pretty rough period, but it has come back strongly in the last few years. I, personally, very vividly remember a specific event and day in 2007 that convinced me we were going to have a financial crisis in the relatively near future. That was the day the music died as far as I was concerned; we had a large and potentially very visible transaction we were working on in the summer of 2007. We were moving along very rapidly and excitedly and one day in early August I was talking to the guy on the syndicate desk and he said, “It’s over.” For me, it was a very clear, bright line. I don’t know if your memory of that market is quite the same as mine, but I would be interested, because that was a pretty critical time for the market, in hearing your observations about that period. And, of course, the question on everybody’s mind: are we now seeing the same play over again – second act?

Randy: Well, yeah, that’s a very good question, John. It’s a question that a lot of investors are asking themselves. I think there’s a danger when people are investing by looking in the rearview mirror. It’s hard to ignore history, but what history are you looking at? In the 2006/7 timeframe that was characterized by a significant excess liquidity, we all remember a lot of the mega-deals that were done. Very large private equity deals; TXU was probably the most famous or influential – that company has since filed for bankruptcy with over $25 billion in equity and debt that was raised for that company. That represented the high-water mark of liquidity – both, in the private equity and the debt markets.

What was going on in that ’06-’07 timeframe was that there were not only a lot of deals being done, but also a great deal of leverage being created in the system. Leverage came not only from, for example, from Collateralized Loan Obligations, (CLOs), but also, the equity that was being put into those CLOs was itself being leveraged. So, the amount of leverage that was put into the system combined with the amount of cash that was floating, looking for yield, created all of the backdrop which one would characterize as a being a bubble. And we know the bubble burst.

There are important differences between then and now – and there are a number of them. If you recall the trouble in 2007 actually started not in the summer but in the spring, with two hedge funds that were owned by Bear Stearns. Those hedge funds were investing in mortgage securities. They ran into trouble and actually had significant liquidity problems. I remember sitting in my office during that period and thinking that was a sign of some problems and wondering whether or not there were other similar hedge funds or investors having the same problems with mortgage securities. Of course, we found out later that that was the case.

The difference now is that, as we know pretty clearly, the mortgage backed securities business is vastly different than it was then. There's much less leverage in the system, there's much less paper being syndicated out to unsophisticated investors. The whole landscape has changed with regard to what actually triggered the crisis. The second thing that's different is that central banks remain very open to pumping liquidity into the system. Even the Fed, which has started to taper back its own purchases, is still purchasing bonds in the open market and keeping the market afloat. Any time Janet Yellen even signals a possibility that may change, the market takes a tumble. So, I think that will continue for a long time. If there's any hint of any issues similar to what happened in '07-'08, the central banks will coordinate to create additional liquidity to cure the problem.

As you may recall, the '07-'08 juncture was really a liquidity problem that was causing the crisis. The third difference is that the economic backdrop of what's going on is very, very different. We've seen a lot of very strong data coming out of job reports and, generally, on the GDP side of the road. The first quarter was sort of a lousy quarter, down almost 3%, though that was a weather related issue, so nobody seems to be worried about it. So, I think that the overall economy, labor picture is much different. Lastly, John, you may remember this, but many of your listeners may forget, that in 2007, the interest rates were significantly higher than today. Just to give you an example, LIBOR was at 4%, or, in some cases, 4.5%. Today, it's probably at 1/10 of that level.

That low rate environment combined with a pretty positive economic outlook is creating a much more stable overall environment in 2014.

John: So, one of the similarities we do see between the two periods is the very high level of valuations for good companies. We are seeing multiples, frankly, for some smaller companies, that we've never seen before. Is that being driven by the debt markets or by the need to put equity dollars to work?

Randy: You've identified both of the movers – both the buoyancy that moves the credit markets as well as the supply-demand dynamics in the private equity markets. So, as you know, all the numbers are pretty compelling. The amount of capital that private equity has raised over the last seven years or so is tremendous. I think the number, globally, is something like a $1 trillion in capital raised. In the US, it's probably $250 billion in private equity capital raised. They need to put that to work, so on the one hand, you've got a lot of cash being brought towards the equity side of the equation and on the other side, you've got all these investors who've dedicated themselves to raising debt capital to chase yield. That capital is looking to partner up with the equity sponsors who are bidding on the available deals.

The problem is, there's a finite number of deals. So, the result of that, or any inflationary equation, is that there's too much cash chasing too few products. So we expect to see the multiples go up, and that's what we're seeing in both the large-cap and the middle market, I would say the one positive in that is that while multiples are high, that also means the amount of equity that's been put into these transactions is relatively high. So, even though you're seeing these double-digit purchase multiples, and therefore some pretty high leverage, those deals are being structured on equity to capital ratios that, are still being fairly conservative. The peak of the market in 2007, as you may recall, we got deals in the low, in some cases, 20% equity to capital and, maybe, even lower. Today, I think that number is probably around 30-35%. So, even at this frothy stage, the capital structures are fairly conservative.

John: We just closed a deal that was 100% equity on a recap, so there's a lot of equity money out there. There've been a lot of new entrants into the overall market, not necessarily the syndication market, but the overall direct lending market, which serves the same middle market area. This is particularly true of the BDCs and a lot of private debt funds have been raised as well. I know back in '07, there were a number of lenders that were basically funding longer-term debt investments with what amounted to commercial paper or very, very short term instruments. Do you see the current crop of investors as being more stable in terms of their funding sources?

Randy: Yes, very much so. That was one of the lessons that was learned back in 2007. A lot of the companies were creating their financing sources using short term capital market funding and warehouse lines. There were a number of middle market firms who tried to get themselves up and running with warehouse lines and when the music stopped, as you so often referred to, back in the summer of 2007, the number of chairs that were available was fewer. So anyone who didn't have long term capital basically didn't have a chair at the table. Today, the amount of long term financing options that you have, both in terms of the number of CLOs that have been done – and certainly, the volume's kicked up significantly this year – the number of business development corporations (BDCs), both public and private, has been pretty outstanding in terms of the new issuance focused on private capital.

In general, the long term commitments that investors are making today to the asset class, whether they're pension funds, whether they're insurance companies, whether they're middle-market money managers, and frankly, whether they're doing it as a part of their own investment strategies as limited partners or whether they're doing it as general partners themselves and creating their own credit funds – they're still looking to put together 5-7-10 year money knowing that when the music stops again, which is bound to happen, they'll have a permanent capital structure block which will make the platform a lot less shaky than it was in '07.

John: So, if I'm hearing you right, you believe that while this is certainly not a market that's immune to hiccups, it is going to continue to grow significantly in the future?

Randy: I do. John. What we do at [The Lead Left] is similar to what you and I are doing right now. I interview people and I've done, probably, 200 interviews over the last 6-7 years. The ones that I've been doing recently, I've been focusing on that very question, which is – "1. Do you see a correction coming?" and "2. How will it happen?" The answer is almost unanimously, that people view, smart money views, us coming up to a point in the not too distant future when there will be a correction. Number two, they believe it will come, probably, from exogenous factors; so, not related to the economy, not related to specific liquidity within the system, but some kind of geopolitical risk.

Open up the pages of the Journal or the Times over the past couple of weeks and you'll see plenty of such risk out there. Where it comes from, nobody really knows. That's the daunting thing about predictions: you can never tell where the risk is coming from. But, the general investor sentiment is that when it comes, there will be opportunity for patient capital, just as there was in '08-'09 – we remember those days when people picked themselves up and dusted themselves off and realized that there were tremendous amount of investments available. You may remember Warren Buffett investing significant amounts of capital in Goldman and in some other major investments that he made and he's known as America's premier investor – he gets in when other people are getting out – and I think people learned a lot from that lesson: so smart money wants to be prepared when the music stops and have the ability to pick up after everyone's left the party.

John: Randy, I know we can go on for another hour and not scratch the surface here and hopefully we can have you back again in the future. Before we get off, tell us a little bit more about what you're trying to accomplish with The Lead Left and who is your audience, who you're trying to serve and what you see in the future there.

Randy: Thank you, John. It's been exciting. One of the things we tried to do with On the Left, which is the predecessor publication, was to provide some clarity and transparency to what is ordinarily a private and somewhat opaque market, which is the private credit market, specifically the middle market. And, as a practitioner all these years, I had not seen any one publication, that I felt, did that. So, I went out and did it on my own. I will say though, we've had terrific partners providing us with content and who I respect tremendously – people like S&P Capital IQ, Pitchbook, Markit, ThomsonReuters – who are all experts in the field of data and research, particularly loan markets, and they've been great partners in this.

One of the advantages to The Lead Left is that it consolidates a lot of this data and my commentary and a lot of the interviews that I do. What I'm trying to do from a practitioner's perspective is to be a tour guide in the loan markets which, at times, can be confusing, directionless, and daunting because the media tends to sensationalize some of these topics. One of my favorite expressions that some of the major media uses when they talk about, for example, the leveraged loan market – they call it risky loans. Well, obviously, if they were risky loans, there wouldn't be a lot of investors getting into it, as opposed to the many billions and, even trillions, of dollars invested safely in the loan market over the last decades. But my role in The Lead Left has been to provide some light, some clarity in the market by talking about these markets as a practitioner and really focusing on the value that the global market brings both, through liquidity and yield – and safety. These are companies that people are lending to through first-out positions with very good yields and have been proven over long periods of time through recessions and downturns. So, understanding the asset class, giving people a voice through interviews and some of the commentary that we do.

We believe our audience is divided very equally between investment bankers, what I would call general service providers to these markets, capital providers, banks, and so forth, and then, private equity. I would say it's split pretty equally amongst those. We currently have about 11,000 readers, having been resuscitated only on April 29th, which was our first issue back. So, we've come back from 0 to 11,000 pretty quickly. We were at one point up to about 30,000 in prior publications, so we are trying to get back to that level. I'm very excited about the kind of content and partnerships such as with your publication Capital Matters, John, that are read by thousands of people and are well known and well respected for a long, long time. That's really what this is about, partnerships and getting information across to our readers that they would ordinarily not get elsewhere.

John: So if anyone is interested in looking into The Lead Left, how do they do it?

Randy: You can go right online, it's www.theleadleft.com and if you have any questions, you can email me at randy.schwimmer@theleadleft.com. John, I appreciate the chance to be with you.

John: We appreciate your time Randy and we look forward to further dialogue in the future.

Randy: Thanks so much!

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