Debt Markets: A Bit of Froth?

Humming Along, but not without Risk

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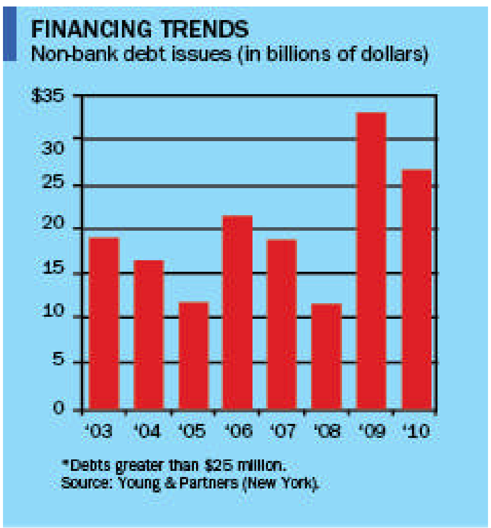
Young: Several potential risk factors.

Debt issuance in the chemicals sector was very strong in 2010, and continues to be robust in early 2011, but some froth is evident in corporate debt markets, bankers say. The significant rebound in debt markets that occurred within months of the recession's end in mid-2009 has continued and now benefits investment-grade as well as high-yield issuers. Bond financing in the chemicals sector totaled $26.7 billion in 2010, down from $33.1 billion in 2009, according to Young & Partners (Y&P; New York), an investment bank. It was the second-highest annual figure since the late 1980s, despite the decline, Y&P adds. "It seems like we've come a bit too far too fast," says Eric Peiffer, managing director/debt markets at KeyBanc Capital Markets (Cleveland).

High-yield volume jumped to $14.1 billion, from $4.9 billion in 2009, even though the overall dollar value of chemical-sector bond issues fell that year, Y&P says. The decline in investment-grade issues was due to a drop in demand. Investment-grade companies satisfied refinancing needs when the market opened up in 2009, says Peter Young, president of Y&P. Interest rates remain low, even for high-yield issuers, and 'covenant-lite' loans, while not quite the norm, are becoming more common.

The strength in the debt market over the past two years has been driven by a healthy supply from lenders and strong corporate fundamentals. Institutional investors and fund managers have put money into a high-yield debt market backed by generally strong corporate balance sheets in an effort to find better returns. Even speculative-grade chemical companies have solid financial profiles after the cost-cutting measures of the recession, says Rod MacDonald, managing director/chemicals at KeyBanc. "They are perceived as being lower risk," he adds. "There are several speculative-grade chemical companies with nine-figure cash balances." These companies include PolyOne, Solutia, and Ashland.



These factors have come into play at a fortunate time for many companies, which have been happy to take advantage of the availability of funds and strong balance sheets to refinance older debt. The "maturity cliff," tens of billions of dollars in debt that was set to come due over the next few years, is no longer a concern, Young says. Many companies, including Dow Chemical and Solutia, recently refinanced with lower interest rates, extending maturities and saving millions of dollars annually in interest payments.

The return of easy availability of corporate debt, combined with a variety of economic risk factors, is leading to some concern about the sustainability of the market. “A lot of participants, especially in high-yield, expect there to be a pause or back up [in the market] at some point in the near future,” Peiffer says.

Several potential hazards, which could unsettle capital markets, are lurking, bankers say. Rising energy prices, sovereign debt problems, withdrawal of government stimulus, and a budding property bubble in China present potential threats to the health of capital markets, Young says. “Among all these things, it is likely that one or two will become a problem,” Young says. “It probably won’t be none, but it probably won’t be all of them.”

Together with the earthquake and tsunami in Japan, these factors are creating volatility in equity markets, says Christopher Cerimele, director and head of chemicals at Houlihan Lokey (Chicago). That volatility could spill over into the high-yield debt market, which is more closely correlated to equities than investment-grade debt, but it is unlikely to “send the market into a tailspin,” he adds. Many market players express concern about the potential negative effects from the disaster in Japan. However, it is far too early to assess with any confidence the impact it will have, bankers say.

Bad news did not undermine the debt market in 2010, however. Last year’s sovereign debt crises did not faze corporate credit markets much, although the situation in Japan may yet work out differently. “With each successive piece of bad news [in 2010], the market was impacted less and less negatively and seemed to improve more and more quickly,” Peiffer says.

Meanwhile, equity financing, not historically a strong point for the chemical industry, remains weak, Young says. About $7.8 billion in new equity was issued by chemical companies during 2010, Y&P says. This figure is relatively high although one deal, Petronas Chemicals’ $4.1-billion initial public offering (IPO), accounts for more than half of it. That was a “unique situation”—a large, profitable, emerging-market play, Young says.

Unconfirmed reports that Bain Capital is planning an IPO of Styron could be the largest chemicals equity deal since Petronas *(CW, March 7/14, p. 8)*. However, any deal is likely to be for a minority stake, Young says. “They want to see if they can get some money by selling shares gradually,” he adds. “You need to have a strong market to sell a majority stake. But they’ll sell a minority and use part of it to pay down debt.” Private equity owners sold shares in Kraton and Rockwood in the same way, eventually selling majority stakes through multiple offerings.