Bond Blog

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M&A REVIVAL A LIKELY TAILWIND FOR HIGH YIELD PERFORMANCE

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Following a brief COVID-related interruption, corporate M&A activity has not just returned, but it has set new records and become a key factor to monitor across corporate debt allocations. Enormous monetary support has provided corporations and private equity sponsors with easy access to inexpensive capital, helping to fuel a revival of acquisition activity through the first half of 2021. Of course, an acquisition can cut two ways in terms of the credit effect on the buyer and the target. In the first of two related posts, we look at the M&A effects on high-yield issuers. These companies have been among the largest M&A beneficiaries as cash-rich investment grade corporates have sought out acquisitions to gain scale and accelerate growth while PE sponsors have sought to invest in companies that will benefit as the economy recovers from the pandemic and to exit existing investments at strong valuations. This has created a market awash in liquidity, likely providing a continuing tailwind behind U.S. high-yield performance going forward.

M&A Revival

U.S. M&A volume totaled $1.27 trillion through the first half of 2021, a 324% increase from the first half of 2020.[1] Meanwhile, U.S. LBO deal volumes have surged this year to levels not seen since before the credit crisis, rising to over $354 billion in the first half of 2021.[1] This sharp rise in deal activity has been supported by strengthening economic conditions, supportive fiscal and monetary stimulus, historically low interest rates, record amounts of unallocated capital, and companies looking to reposition themselves for the post-pandemic world.

Meanwhile, the capital markets are running on all cylinders, which, along with low interest rates, ensures ample liquidity to finance deal activity. U.S. high yield gross issuance totaled $364 billion through the first eight months of 2021, up from $299 billion through the same period in 2020.[2] While the vast majority of that was used to refinance existing debt, acquisition financing accounted for $57 billion, or 16%, of that total. For context, for full-year 2020, acquisition-related high yield bond activity totaled only $38 billion (Figure 1). Yet, the recent M&A-related issuance in the high yield market doesn't necessarily mean that companies are levering up on their own. Instead, many are the issuing entity in the latest flurry of leveraged buyouts, which importantly include greater equity contributions than those seen in prior LBO booms.

FIGURE 1: ACQUISITION-RELATED ISSUANCE TICKS HIGHER

Source: JP Morgan High Yield and Leveraged Loan Market Monitor as of September 1, 2021.

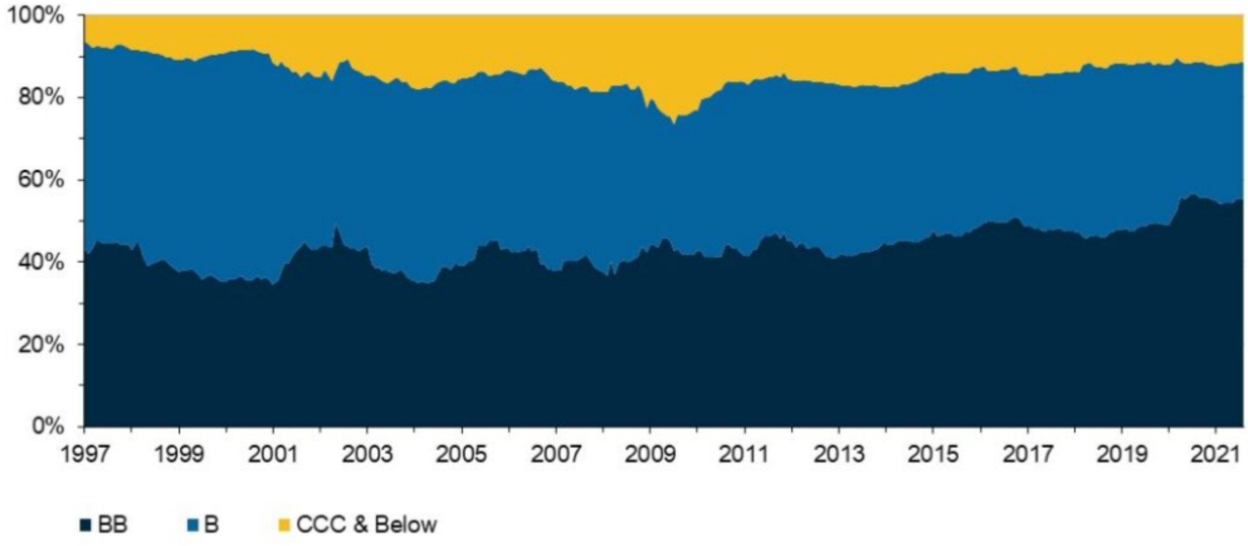
The Return of the Jumbo LBO

PE firms have particularly benefited from the favorable financing environment and have increasingly accessed the market via their acquisition targets to finance a portion of the transaction. PE firms are currently sitting on $1.6 trillion of dry powder, according to Preqin, and have been quick to deploy that capital as opportunities arise.[3] The recently announced $30 billion acquisition of medical supply company Medline by a PE consortium including Blackstone, Hellman & Friedman, and Carlyle is not only the largest LBO of 2021, but it also likely heralds the return of club deals that may usher in a subsequent wave of large-ticket LBOs. Importantly, sponsors are reportedly contributing roughly 50% in equity as part of the Medline transaction, which compares favorably to the 30% to 35% equity-check contributions seen during the LBO wave of 2006-2007.

While most of the recent LBO activity has focused on more COVID-resilient sectors, such as technology and healthcare, PE firms are beginning to invest in businesses operating in more hard-hit sectors at attractive valuations. Hertz's recent acquisition by Apollo Capital, Knighthead Capital, and Certares Opportunities LLC is just one example. Hertz filed for bankruptcy in May 2020 after travel demand cratered due to COVID-19 lockdowns. At the time of its bankruptcy filing, Hertz's notes were trading below 10 cents on the dollar, but recovered following the announcement of the transaction to trade at or above par on a plan to repay unsecured bondholders in full.[4]

Like most recent LBOs, Hertz's acquisition and emergence from bankruptcy will be funded in the leveraged loan market, which has remained the preferred avenue for sponsors in 2021. Through the first eight months of 2021, U.S. leveraged loan issuance totaled $601 billion, $188 billion of which was used to back acquisitions.[2] Notably, the proliferation of LBO-related loan issuance has contributed to the shift to a lower-rated composition of the loan market in recent years even as the credit quality of the overall high yield market has continued to improve (Figure 2).

FIGURE 2: CREDIT QUALITY OF HY MARKET CONTINUES TO IMPROVE



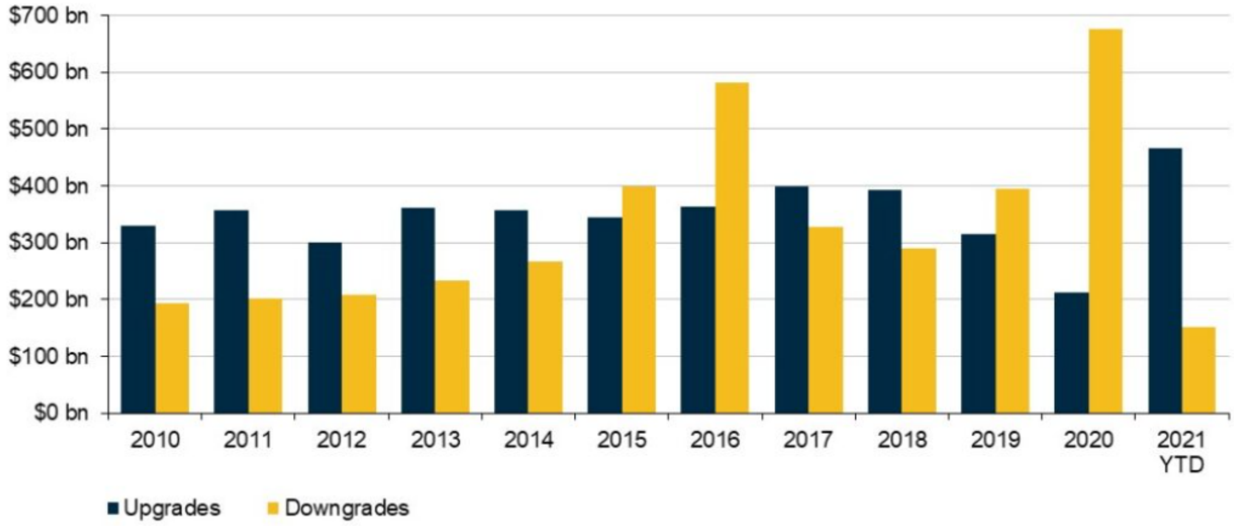
Source: Bloomberg. As a percent of the ICE Bank of America Merrill Lynch High Yield Master II Index. As of August 31, 2021.

Acquired by Stronger Companies

While there were a record 144 sponsor-backed M&A transactions in the first half of 2021, cash-rich investment grade corporates have also been a source of acquisition activity. In June, BBB-rated issuer Vulcan Materials agreed to acquire U.S. Concrete for $2.1 billion in cash to bolster growth and expand its geographical footprint. The announced details of the transaction stipulated that U.S. Concrete's debt, including $300 million in outstanding high yield notes, would be called and repaid in full, causing the bonds to rise six points following the announcement.[5]

Acquisitions of high-yield issuers by investment-grade companies accounts for a number of positive ratings actions in 2021 as the number of upgrades have outpaced downgrades by more than 2:1 through the first eight months of the year (Figure 3).[6] Among these are a group of rising stars, including WPX Energy Inc., Parsley Energy Inc., QEP Resources Inc., Fiat Chrysler, and Norbord Inc., which were upgraded to investment grade after being acquired by stronger companies or combining with another company to make a new, stronger credit. As of September 1, 2021, the number of rising stars totaled 20, or eight more than in full-year 2020, for a total of $26.2 billion that has left the high yield market.[7]

FIGURE 3: RISING STARS AMONG THE WAVE OF UPGRADES



Source: JP Morgan High Yield and Leveraged Loan Market Monitor as of September 1, 2021.

Repayments as Technical Tailwind

Although straightforward refinancing activity accounts for the bulk of all high-yield call volume so far in 2021, exercised call options as a result of acquisition activity should not be discounted. Year to date, high yield call volume has totaled nearly $208 billion, which, along with tenders and maturities, has contributed to a robust technical backdrop even as gross new issuance volume nears a record high. Despite strong year-to-date gross issuance, the net supply surplus totaled only a little less than $5 billion through August 31, 2021 as more high yield debt has left the market as a result of calls, tenders, maturities, coupon payments, and rising stars.[8]

We believe the recent surge in M&A activity should be counted as one more factor - in addition to strong corporate earnings, improved fundamentals, and a decline in default rates - helping to support overall high yield performance. As more high yield issuers are acquired by PE sponsors looking to deploy capital and by larger, well-capitalized companies looking to reposition as the economy continues to transition, an active M&A market is likely to remain a tailwind and contribute to further high yield spread compression through, at least, the first half of 2022. In a subsequent post we will examine some of the drastically different effects a resurgence in M&A activity will have on the investment grade corporate market and why we believe it remains a key risk for that market going forward.

[1] White & Case, U.S. M&A Hits Record Highs, July 30, 2021.

[2] JP Morgan High Yield and Leveraged Loan Market Monitor, September 1, 2021.

[3] White & Case, Private Equity Goes Back to School, August 20, 2021.

[4] Bloomberg.

[5] Standard & Poor's.

[6] JP Morgan High Yield and Leveraged Loan Market Monitor, September 1, 2021

[7] Ibid.

[8] Ibid.

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