Volatility and Uncertainty Continue in the US Capital Markets

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The U.S. capital markets experienced continued volatility throughout much of 2016, as the bond and equity markets were affected by a series of significant events: the November U.S. presidential election; the June Brexit vote; fluctuating oil prices over the course of the year; the Federal Reserve's December increase in interest rates, only the second since 2006; and a variety of geopolitical events throughout the year, most notably with respect to China and Russia.

How the U.S. capital markets perform in 2017 will largely depend on how and whether the Trump administration implements its proposals, and how those policies complement or contradict one another in their impact. Until there is some clarity on these issues, the markets may again experience volatility related to the new administration.

High-Yield Debt Market. The U.S. high-yield market in 2016 ended the year approximately 15 percent lower by dollar volume and 23 percent lower in number of issuances than 2015, the third consecutive year of decline.[1] U.S. high-yield bond issuances totaled $245 billion (486 issuances) in 2016 compared to $288 billion (634 issuances) in 2015. Acquisitions and refinancing activity continued to drive volume last year; however, M&A issuances (including leveraged buyouts) decreased to approximately 19 percent of total volume in 2016, compared to approximately 33 percent in 2015. In addition, energy sector issuers remained active in the market, with exchange offers and other restructurings and — particularly with stronger oil prices in the fourth quarter — traditional refinancings. (See "Oil and Gas Industry Seeks Steady Ground Following Year of Restructurings, Restrictive Lending.") December 2016 was the busiest December for high-yield issuances since 2013, with refinancings accounting for 69 percent of dollar volume.

Investment-Grade Debt Market. The U.S. investment-grade debt market in 2016 once again had record dollar volume — approximately $1.35 trillion (1,881 issuances) — exceeding the previous record of $1.32 trillion (2,177 issuances) set in 2015 and marking the sixth consecutive year of dollar volume increase. The total dollar volume was driven in part by several large acquisition financings, including: $46 billion by Anheuser-Busch InBev NV to finance its acquisition of SABMiller Plc (the second-largest bond offering ever behind Verizon's $49 billion offering in 2013), $20 billion by Dell Inc. to finance its acquisition of EMC Corp., and $15 billion by Abbott Laboratories to fund its acquisition of St. Jude Medical. In addition to M&A issuances, the investment-grade volume in 2016 was driven by issuers refinancing debt in anticipation of interest rate increases as well as potential volatility and uncertainty associated with the implementation of President Donald Trump's campaign proposals. Banks and financial issuers represented the largest total number of issuances by sector in 2016 (almost 50 percent) and approximately 42 percent by dollar volume, as banks issued new bonds both to replace maturing debt and to prepare to meet total loss-absorbing capacity rules adopted by the Federal Reserve in December 2016. The rules, which go into effect January 1, 2019, require banks identified as global systemically important banks to maintain a minimum level of long-term debt that could be used to recapitalize critical operations upon failure. They also set a new minimum level of total loss-absorbing capacity, which can be met with both regulatory capital and long-term debt. Strong investment-grade issuance volume — dominated by banks and financial issuers — continued into early 2017, with a record $44 billion of dollar volume in the first two days of the year. Year-to-date 2017 investment-grade issuance is nearly $150 billion, a record high for January.

[1] Sources for the data in this article are: Dealogic, Debtwire, highyieldbond.com, S&P Capital IQ LCD, Bloomberg and Thomson Reuters.

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Equity and IPO Markets. The U.S. equity markets reached record levels, starting in December 2016 and continuing into 2017. Toward the end of January 2017, both the Standard & Poor's 500 index and the Nasdaq composite set new all-time highs, and the Dow Jones industrial average topped the 20,000 milestone. The records were driven by strong fourth-quarter earnings and executive orders from President Trump that provided some clarity on infrastructure policies, including accelerating the completion of the Keystone XL and Dakota Access pipelines and easing the regulatory burden for domestic manufacturers.

Despite the recent positive tone in the markets, volatility in the first half of 2016 depressed the initial public offering (IPO) market throughout most of the year, with only 105 IPOs raising approximately $20 billion, compared to 174 IPOs raising over $34 billion in 2015, representing the lowest dollar and issuance volumes since 2003 and 2009, respectively. The five largest IPOs in 2016 accounted for over one-quarter of the dollar volume, and the leading sectors by dollar volume were financial services and health care. Financial services and health care companies also had the greatest number of issuances, followed by technology issuers. Several companies that filed for IPOs in 2016 or were considered candidates for IPOs in 2017 (including Dollar Shave Club and Centennial Resource Development Inc.) instead consummated a sale process, which can provide a quicker path to liquidity, particularly for private equity firms looking to exit older investments. Special purpose acquisition companies (SPACs) continued to access the IPO market in 2016, with 13 SPAC IPOs raising $3.5 billion (down from 20 SPAC IPOs raising $3.9 billion in 2015, but still well above dollar levels in 2008-14).

Follow-on volumes in 2016 also were down materially from prior years, particularly with respect to marketed transactions. Despite the decline in overall follow-on activity, however, 2016 was a record year for block trades (which represented 57 percent of total follow-on proceeds raised), as issuers sought execution certainty and a transfer of risk to underwriters.

Looking Ahead

Implementation of President Trump's campaign proposals has the potential to significantly impact the U.S. capital markets throughout 2017, as do a wide variety of exogenous political and global macroeconomic events. As in recent years, repeat issuers and companies with strong fundamentals, especially those in sectors that stand to benefit from President Trump's stated policies, are likely to continue to have the best access to capital if volatility returns. More highly leveraged or distressed companies may need to seek alternative financing solutions and creative structures, as evidenced in recent years in the energy sector. In a positive sign for the IPO market, a healthy backlog continues to build, and investors have begun to rotate their portfolios back into equities, reversing a multiyear trend. So far, 2017 is off to a strong start, with a number of companies having launched or priced their IPOs in the first month of the year. However, some private companies may continue to delay IPO plans in favor of private capital raises, particularly with the increased number of shareholders allowed before a company is required to become a Securities and Exchange Commission reporting company.

M&A and Refinancing. A more favorable M&A environment under President Trump could positively impact both the debt and equity capital markets. Many of President Trump's cabinet appointments have made careers in leveraged buyouts, which could further impact the M&A environment. The expectation is that a robust M&A market (see "Mergers and Acquisitions: 2016 Update") will drive significant acquisition financing. Similarly, at the beginning of 2017, issuers likely will continue to take advantage of the still relatively low interest rate environment to effect opportunistic financings or refinance existing near-term debt before interest rates rise.

Fiscal Stimulus. President Trump's policy statements, including the promise of a large infrastructure investment, are expected to stimulate the economy if they come to fruition. Fiscal stimulus, together with corporate tax cuts, could improve corporate profits and result in higher stock prices and a stronger equity market. However, more protectionist trade policies could have the opposite effect. In addition, policies that are favorable for the equity market often have the opposite impact on the bond market. Growth-oriented fiscal policies could increase the threat of inflation and result in a faster pace of Federal Reserve interest rate increases, which would negatively impact the bond market. (See "Significant Changes Likely for US Trade Policy and Enforcement.")

Corporate Tax Reform. Corporate tax reform, if enacted, is expected to have a significant positive impact on the equity markets but could negatively affect the bond markets. (See "Business Tax Reform All but Certain in US, Europe.") An inability to deduct interest on bonds or a reduced corporate income tax that makes deductibility less valuable could make bonds, particularly high-yield bonds, less attractive. However, an ability to expense capital investments could benefit the bond market if companies issue debt to finance these investments. Similarly, if repatriation of corporate cash held abroad is facilitated with a lower tax rate, companies that benefit — including investment-grade technology and pharmaceutical companies — may need to raise less cash in the bond markets for share buybacks, dividend recaps, M&A and other purposes. Yet share buybacks and M&A activity, combined with higher capital spending and additional hiring that likely will occur with repatriation, are bullish indicators for the equity markets.

Financial Deregulation. The possible repeal of the Volcker Rule and the loosening of other Dodd-Frank Act regulatory standards could strengthen the bond market, particularly the high-yield

Volatility and Uncertainty Continue in the US Capital Markets

market, by allowing banks to once again provide trading liquidity for high-yield bonds and underwrite bonds for more highly leveraged issuers. (See "The Trump Impact: Key Issues in Financial Services Reform for 2017.") Deregulation also could positively impact the equity markets, particularly financial stocks, and encourage additional issuances.

Equity Backlog. Following consecutive years of below-average issuance levels (by volume), a significant pent-up backlog exists across industry verticals. Conditions look ripe for issuance activity to pick up in 2017, fueled in large part by a recent recovery in corporate earnings, improved performance of the 2016 IPO class as compared to 2015 and an investor base that is underweight in its equity investment allocations by historical standards. The IPO of Snapchat's parent, Snap Inc., is expected as early as March with a valuation in excess of $20 billion according to some sources. While the overall IPO market may be less focused on these so-called unicorns, the technology sector is poised for at least a modest recovery, and successful IPOs in the early part of 2017 could lead to greater offering activity during the year. In addition, the financial, energy and industrial sectors are expected to see significant upticks in equity issuances given prevailing pro-growth, anti-regulation and protectionist themes, combined with a recovery in oil prices and rising interest rates. These trends clearly favor domestic issuers, whereas foreign issuers or those with significant overseas exposure likely will be viewed more skeptically by investors, given geopolitical uncertainty, a strong dollar and fears around global trade. Overall optimism surrounding the equity markets is balanced between IPO and follow-on activity. One of the big unknowns, however, is the way in which the sponsor backlog will play out, with private equity shops largely pursuing dual-track processes. But with a target-saturated environment in many verticals and a sense that the bull run is in or nearing its final phase, the bias may be toward near-term IPO exits.

Strength Across Sectors in Equity Markets

Based on views of equity capital markets and syndicate bankers across Wall Street, the prevailing expectation is that most sectors should be active in the equity markets in 2017.

Technology. There is a consistent sense on Wall Street that technology companies will help lead the charge in the recovery of the IPO market. Smaller-scale, high-growth companies with high revenue visibility, such as software companies, are likely to form the initial wave, though significant pent-up supply of internet and e-commerce companies exists, which could generate larger deals. Snapchat's plans to launch an IPO as early as the first quarter of 2017 may be the catalyst the tech market needs.

Health Care. While uncertainty around the fate of the Affordable Care Act may be disruptive to certain subsectors such as hospitals and services, a healthy rebound in life sciences issuance is expected. There are a significant number of biotechnology and pharmaceutical companies in the near- and medium-term pipeline, and already there have been a number of launches and public filings, including five IPOs and eight follow-ons launched as of January 27, 2017, on the back of a historically well-attended health care conference for investors and pharmaceutical executives.

Industrials. Industrials have rallied significantly on the prospects of increased infrastructure spending and protectionist trade policies. A number of capital markets professionals expect this to lead to significant equity issuance as well as debt refinancing activity. Pitch activity has been robust in recent months, and a few near-term public filings and launches are expected. Much of the supply remains sponsor-backed, with a number of longer-held positions ripe for exit. Companies in the building products and materials space could be particularly active, as could issuers tied to the steel market.

Energy. The trend toward consolidation, particularly in the exploration and production (E&P) space, is projected to continue, as players maintain their focus around the Permian Basin in Texas and New Mexico. That likely will drive a significant need for acquisition financing. However, many targets believe that oil price stability and a positive outlook for the industry will finally thaw the IPO market, and they have begun to engage in discussions with banks. A clearing of the E&P backlog would pave the way for issuances in the midstream space, where many master limited partnerships (MLPs) have been delaying capital spending as they wait for the equity markets to reopen.

Financial Institutions. The promise of decreased regulation, rising interest rates and a steepening yield curve have improved the outlook for the sector, resulting in expectations that significant post-election follow-on activity will continue and the market will see a reinvigorated IPO pipeline (including many IPOs that have been on hold for long periods). Banks are likely to be among the most active issuers, both in the IPO and follow-on markets, though there are a handful of insurers and reinsurers in the pipeline. In the specialty finance and business development company (BDC) space, many issuers are starting to trade back at or above book value. If that trend holds, there is likely to be a decent number of new issuances.

Consumer. The near-term IPO pipeline of sponsor-backed companies is relatively moderate, as much of the supply in this sector has been brought public in the last couple of years. However, there remain concentrated positions in a number of these companies, and sponsors may look to monetize those holdings aggressively if the market remains open. In addition, a number of nonsponsor-owned, high-growth retail names are starting to engage in IPO discussions. Investors currently seem to favor hard goods retailers, particularly those with a strong e-commerce platform, and the food and beverage sector is expected to remain strong.

Real Estate. Real estate investment trusts (REITs) struggled in 2016, underperforming the S&P 500 and suffering from elevated trading volatility as investors have rotated out of the space. The recent interest rate hike and the promise of more have not helped. However, certain areas such as hotels and residential- and consumer-driven sectors have the potential to outperform the broader sector, leading to potential equity issuances. Overall, the IPO pipeline is moderate, with a couple of large potential debuts expected and a number of midsized hotel and multifamily operators that may choose to test the market.