Exchanges at Goldman Sachs

Raising Capital: How Corporate Financing Strategies Are Evolving

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Allison Nathan: This is Exchanges at Goldman Sachs, where we discuss the developments shaping industries, markets, and the global economy. I'm Allison Nathan, a senior strategist in Goldman Sachs Research. In today's episode, we're going to take a look at how the volatile markets and tightening financial conditions are affecting companies' ability and willingness to raise capital. To help us understand how companies are approaching their financing needs in today's economic climate, I'm delighted to be joined by Beth Hammack, Goldman Sachs's co-head of the Global Finance Group within our Investment Banking Division. Beth, welcome to the program.

Beth Hammack: Thanks so much for having me, Allison.

Allison Nathan: So just to set the stage, companies have raised a record amount of equity and debt across the capital markets thanks to record low interest rates. We've had, you know, a ton of monetary stimulus coming through the economy, and there has been strong investor demand. But we seem to be at an inflection point. You know, we are entering a period where the Fed is going to be raising interest rates. The market is responding to that. So how have financing conditions evolved for companies in general?

Beth Hammack: So 2021 was a spectacular year for financing. We had record issuance markets in equity, not quite record in debt but very strong markets in debt, and obviously 2022 is shaping up to be something quite different. The volatility that we've seen from the beginning of this year really kicked off with, as you noted, the Fed and the rhetoric change that they had coming out of the minutes that we got on January 6th and then moving into their first meeting that they had later that month. And all the way through we've seen the markets now gearing up for the first hike happening in March.

And I think we went from a period coming of the end of last year where we had really robust amounts of fiscal stimulus, monetary accommodation put in to where, in a pretty short period of time, the markets have started pricing in not one or two hikes for the year but six or seven hikes for this year with rates moving up pretty significantly. And so you've really seen companies and the markets start to re-think valuations and re-think about what that's going to mean for the overall financing picture.

And so markets have been open, for sure, but it's been a little bit more stressed. We've seen some markets being incredibly robust. The leveraged finance market continues to be incredibly strong, driven by a lot of sponsor activity. But the equity markets have been more challenged. And we've seen a lot of that underlying volatility in the equity markets play through both in valuations, in sector rotations, and a lot more different themes that I'm sure we'll dig into.

Allison Nathan: Yeah. I mean, if we could talk a little bit in more detail about access to the capital markets right now, how does it really compare to what we saw last year?

Beth Hammack: Access is still there. The debt markets are robust, so in January we actually had the largest amount of LBO issuance in the leveraged finance markets that we've seen since October of 2007 at $30 billion. So it was really strong. There's a lot of demand in certain pockets of the market, things which are floating rate are getting more demand than what we're seeing in the fixed-rate market. But the equity markets have been really challenged. The problem in the equity markets, particularly from an issuance perspective, is that it takes a while to go through the process of doing an IPO. And when you have market volatility and valuations changing so rapidly, companies, when you're taking that really pivotal moment of coming to the market for the first time, they want to know that they've got a stable backdrop and that they've got some confidence around where their deal's going to price and how it's going to be received.

And when you have markets moving 2% a day up and down in different directions, it just makes it very hard to navigate that.

Allison Nathan: And do you think there's going to be more volatility as we come up to the next Fed meeting? And ultimately, do you think a lot of this is priced in and the market is expecting what's to come? Or there could be more volatility?

Beth Hammack: Well, there certainly could be more volatility, though I wouldn't imagine it'll be driven by the Fed at this point. I think the market is certainly thinking about what the Fed's going to do at this particular meeting, whether it's 25 or 50 basis points. But in reality for investors, 25 or 50 or what they do on the front end really isn't the key issue. It's really about that long-term rate, about how many hikes they think we're going to have and how quickly the Fed is going to get to whatever their terminal rate is. So everyone agrees that rates are going up; it's just a question of how much and how far we're going to end it.

Where I think volatility is likely to come from is probably geopolitical events as we've seen from the past week. And so obviously the events in Ukraine and Russia came on much faster than I think the market was anticipating, and obviously that's created a lot of uncertainty. The sanctions that are being rolled out, very tremendous and having broad impact as I think the governments, the coordinated Western governments, desire.

But I think there are other forces at play that clearly could drive more of the volatility ahead.

Allison Nathan: And at this point, it does seem that, as you said, interest rates are going up. And so are you seeing any indication that companies are just willing to borrow less, looking at a higher cost of borrowing?

Beth Hammack: You know, rates have gone up modestly, so we talk about them going up and it feels like it's transformational. But you have to remember that the 10-year rate is still right around 2%, you know, either side of it at any point in time. And so right now we're down to about 1.75 given the geopolitical events. And so in the grand context of the past 5 or 10 years, it's actually quite low.

We've also seen over the past couple of years that companies really did a lot to shore up their balance sheets, and so companies are entering this period with really strong balance sheets, having refinanced very heavily through 2020 in the height of the COVID crisis and also last year in 2021 when there was tremendous stimulus and accommodation demand. And so what we've seen this year is a modest widening in credit spreads. So in investment-grade, spreads have widened around 50 basis points year to date. And in high-yield, it's probably around 150 basis points.

Now, that sounds like a lot. Those are big numbers. But if you look over a past 10-year average, we're still in the tighter part of that. We're below that 10-year average on a relative basis. And so it still is a reasonably attractive time for companies to come to market. And so again, the debt markets have been pretty robust. The equity markets, as we talked about, given volatility, a little less so. But our pipeline is growing, so there are still plenty of companies that want to come to market and want to look at it. And we're seeing them spend more time on the other part of their balance sheet, particularly companies who think that their stock has been really undervalued by the market, looking at share repurchases.

Allison Nathan: So talk a little bit more about that, about the activity in the pipeline. Like, where do you see it coming from? What do you expect 2022 might look like?

Beth Hammack: So our pipeline is very robust. It's as high as it's been and it continues to grow. The backlog grows, unfortunately, given that execution in the marketplace has been more challenged. I think what we'll find if the markets stay this volatile and stay closed is that companies will try to find alternative ways to come to market.

So whether that is take privates through whether it's sponsor activity or just buying back meaningful shares of the company, that's one way of thinking about it. Another is they could look to do things, for companies that have outstanding debt, they could look at follow-ons would be we think quite common. And the private markets have been very robust. So whether it's pipes, private investments in public equities, or more traditional non-registered transactions, convertible debt, other types of solutions, there are a lot of opportunities and options available to companies right now.

Allison Nathan: One of those options that we've talked a lot about on this podcast is SPACs.

Beth Hammack: SPACs.

Allison Nathan: You know, they were so in focus in the last year or two really, and now it looks like a much more challenging environment. So what are you expecting from that side of things?

Beth Hammack: It is a much more challenging environment for SPACs. You know, the SPAC IPO has been really difficult this year. Last year was a tremendous record in terms of what we saw and really an anomaly, if you look from a historical context, in terms of the amount of issuance that we saw in that space. You know, it was over 500 deals last year. Raised I think over $600 billion of capital in that market. And so it was really a tremendous capital raise in blank check companies, companies that maybe had had some track record of leadership or picking opportunities but not necessarily as robust.

And so what I'd say is, because last year was so robust and we did see a tremendous number of DSPACs last year as well, this year clearly can't compare. One of the trends that we've seen this year is that a lot of those DSPACs from last year, those SPAC mergers, are actually trading below the IPO price. And so that's putting pressure on the thesis and on these companies. One of the benefits of doing a merger going public through a SPAC is that you can use projections, but the market really relies on those projections and thinks about where companies are going to be over the longer term. And a lot of these companies that were created in this way haven't met those projections, and so I think that's putting pressure on the market.

The other thing that we've seen so far this year is that redemptions are high. So when you have that moment of the combination investors have the ability to redeem if they don't want to join part of the new company going forward. And while that was running I'd say in the 40 percents last year, it's running in about the 80 percents now. And so the certainty of that capital raise in that DSPAC merger is not quite what it was in 2021.

The other trend that we're keeping a close eye on is there are still 600 SPACs out there that are looking for partners that went public last year in this format that are looking for deals to consummate over the course this year. And so we do think that that hunt is going to continue, but obviously the bar is going to be higher given these higher redemptions that we've talked about.

Allison Nathan: At the end of the day, it is all about performance. What do you think that underperformance, that high level of redemptions owes to?

Beth Hammack: I think what it owes to is a real change in tone in the market. So with the new macro environment, with the Fed tightening, what we've seen is a real re-rating of growth. And you've seen a shift in terms of the hot sectors in the equity markets and what people are looking at. So last year, a lot of these SPAC mergers, DSPACs, were really in the tech sector, and you've seen some real pressure in tech companies, particularly this year, particularly on companies that aren't able to show profitability.

There's a real focus right now on profitability. So you're seeing the very top of the equity market, the largest, most concentrated, most important technology companies continue to do very well. But these companies that have a promise of profitability, have good revenues, have good growth stories, but haven't been able to turn a profit yet, there's a lot more uncertainty about this given the rising rate environment and the amount of stimulus that's coming out of the economy. And so that I think is one of the key drivers.

Allison Nathan: You already started talking about other structures in addition to SPACs but, you know, are we setting up for spinoffs? What else are CEOs thinking about right now?

Beth Hammack: Spinoffs has definitely been a hot topic. That's one where we see a lot of focus on this concept of shrink to grow. So the ability to take your company to a more narrow, more dedicated focused goal has been one that has really been popular through the end of 2021 and into 2022. It gives management greater focus on the independent business lines. It allows them to tailor the capital structure to be more efficient for the business that they're running. And it allows them to have a currency in their business that they can use for future M&A that's more appropriate, gives them a better multiple for the business that they're running.

And so we continue to think that this is going to be a place where we'll see a lot more interest.

Allison Nathan: And what about share buybacks in this environment? Is that something that companies are focused on?

Beth Hammack: So we've seen a tremendous pickup in share buybacks this year. It's been incredibly robust. This year, we're at 230 billion that's been announced relative to 218 billion at this time last year. And one of the things that we're seeing given how the debt markets, though we've talked about the fact that rates are elevated and spreads are wider, we're seeing companies issue debt to engage in share repurchase. So just last week, we did a high-yield bond for Twitter, a billion dollars at a 5% coupon that they used to fund or partially fund a share repurchase, including an accelerated share repurchase, or ASR, of $2 billion.

And so we see companies saying that they view their stock as being undervalued, and they want to send a strong message to the markets. And so they're going in and engaging and buying back their stock.

Allison Nathan: And so let's drop more into the fixed income side. You started talking about this, but what are the ways in which companies are pursuing debt in this environment?

Beth Hammack: So one of the trends we've seen this year is that the loan market, which is typically floating rate and a little bit higher in the capital structure than the bond market, particularly in the leveraged finance or high-yield space, has been much more robust. And so we're seeing tremendous demand in the bank loan space and a little bit less so in the bond space. And so typically those markets tend to be somewhat balanced, but issuance so far this year is 36 billion in high-yield bonds but 97 billion in loans. And so that 25/75 shift is really somewhat anomalous and reflective of the higher rate environment that we're entering.

That said, we're seeing a couple of other themes underlying that as well. One is continued credit dispersion. And so you're seeing a real differential and a real underwriting of the companies. So maybe at points in 2020 or 2021 it was just about getting your hands on paper and it was just about finding a place to put your cash, given the overwhelming amounts of cash that we had in the system. This year, investors can be choosier, and they're doing a lot more diligence. They're doing a lot more diving deep into the companies and into the underlying financials to understand what the business proposition is.

That said, you know, leverage still seems reasonably contained. We're not seeing a lot of deals push above that 7x leverage which can be a concern for a number of different metrics in terms of interest coverage and how stressed companies can be over time. And in the investment-grade space, we've seen tremendous amounts of financial issuance so far year to date. Corporates have also been very engaged in the market. But the financials, I think they tend to be a little bit savvier about how rate markets are trending, and so you've seen them come very strong early in the market to take advantage of low rates.

They tend to be a bit more shorter dated in the duration that they issue. Tends to be more in that 5-year type part of the curve. And so the average duration that's come to market has been shorter. That said, we are seeing corporates look to lengthen their duration. And particularly corporates who have much larger debt footprints. So someone like an AT&T, who has the largest debt footprint outstanding, also has the longest duration of any issuer outstanding, which helps them to have more certainty that they'll be able to meet their interest coverage one-over time. And so that's a trend, this extension in duration, that we expect will continue through the year.

Allison Nathan: Right. Consistent with a changing interest rate environment, lengthening duration.

Beth Hammack: Exactly.

Allison Nathan: And again, when we think about the themes we continue to hit on in our podcast, ESG is one of them that stands out. How is the focus on ESG right now translating to financing needs for companies? And is this playing out differently across different sectors, products?

Beth Hammack: The trends in ESG this year really have been around delivering on commitment. And so we've seen companies who made a bunch of commitments last year leading up to COP26 and really identifying what they wanted their positioning to be. A number of net-zero commitments from some of the largest corporations out there. And I think these companies are really working through how can they best meet those commitments, and it's going to be really a variety of ways.

So one may be looking at business lines that no longer meet their longer term ESG goals, so looking to divest in those businesses. Another might be doing some structured finance to raise funds that they can use to invest in alternative energy and other transition projects. And a third might be looking at carbon offsets. Can they buy carbon offsets? And that's a market that's just starting to emerge but one we think has even more promise when we get better standards and better consistency around how you evaluate some of these different projects.

And so one of the things we're finding is that not all of these goals and aims are created equal, and every company has its own take on how they want to approach this problem. But getting some more standardization in the ESG space we think will be really welcome. And there's been a lot of leadership by both the EU and the UK. The US is coming on now. We've heard the treasury department and other regulators talking about this and talking about how can we get better transparency, better standardization in the market? And so that's a place where I think we'll see a lot more coming this year.

Allison Nathan: The other big focus: Digital assets.

Beth Hammack: Digital assets.

Allison Nathan: How is that impacting the innovation we're seeing in the capital markets or the capital markets more broadly?

Beth Hammack: So I think digital assets is phenomenally interesting, and I think it's a tremendous white space that we can continue to innovate in. Frankly, to me, one of the least interesting things about the digital asset space is what is today's price of bitcoin? For me, it's something that's out there, it's something we pay attention to. But where it's going at one point or another I don't think is a bigger signal of overall macro trends and overall financing environments for our clients.

But I do think that digital assets holds a lot of promise. You see the investor base looking for ways to access their investments and their money the way they do in consumer space. And we've seen such tremendous innovation in the consumer space where you can move money in an instant using various apps and various closed network programs, whether it be PayPal, Venmo, other types of situations where you can move money very quickly. And I think what you're seeing now in the market space and in the institutional space is you'd like to see some of that tokenization or digitization of assets as well.

Obviously this is very difficult to do because it's a highly regulated space for good reason. We need to make sure we've got the investor protections in place that our customers need. But I think there's a lot of opportunity for us to use defi broadly to help move things online and move it into faster, whether it's faster settlements, faster transitions.

Certain markets, as you know, will take place over long periods of time. And so when I look at the loan market, this is a market that still happens in spreadsheets and faxes, right? That's a place that is ripe for disruption and innovation. But you're even seeing it in the classic bond market. So last year, we did a digital bond for the EIB, which was the first of its kind, really a proof of concept to show that you could do an on-chain issuance for an institution. And I think we'll see more of that this year.

I think we'll see the tokenization move into other places. So maybe not just securities but maybe hard assets. Could be real estate. Could be other things. But I think this is an incredible white space that's drawing a lot of innovation and attention.

Allison Nathan: Let's end with your outlook for corporate financing in 2022. We've talked a lot about what you expect this year, but we have come off a few years where companies were raising capital to make strategic acquisitions. They were acting very offensively. Do you think this is a year where they will pivot to acting more defensively?

Beth Hammack: I think volatility creates opportunity. And so we're going to see companies look to invest in their strategic growth over time. And for some of them, that may be some of the spinoff shrink to grow, which you could view as being defensive. For some of them, it will be finding companies that they think are undervalued and looking to do more acquisitions and to grow from more classic M&A type fashion. So I think there's going to be a lot of opportunities this year.

As we've talked about, balance sheets are strong. I think companies are in a good position to weather this new rising rate environment. And I think it'll depend on what we see in the broader geopolitical space in terms of how much do we need companies shifting back into their domestic footprint, moving away from sort of this globalization trend into more of a regionalized or localized excellence.

Allison Nathan: We will all be watching how this evolves. Thank you so much for joining us, Beth.

Beth Hammack: Thanks for having me, Allison.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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