Financial Crisis Anniversary: For Corporations and Investors, Debt Makes a Comeback

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Oil worker Jeremy Barnett positions a pipe Wednesday at a well site near Hennessey, Okla., that belongs to Gastar Exploration, which financed the site's purchase with junk bonds.

Looking back, J. Russell Porter said his company was "almost at death's door" when the U.S. economy hit bottom.

With credit markets near frozen, he said, Gastar Exploration in 2009 couldn't find banks or investors willing to provide the $35 million the oil-and-gas producer needed to refinance its crushing debt.

Mr. Porter, Gastar's chief executive, concentrated on survival. He sold off a major project and repaid most of the company's obligations. In financial terms, Gastar was deleveraging, or reducing its dependence on debt to minimize risk, part of a broader trend triggered by the financial crisis.

In this special Crisis Plus 5 series of The Big Interview, John Thain, CEO of CIT Group and former CEO of Merrill Lynch, and WSJ Financial Editor Francesco Guerrera discuss the outlook for Wall Street. Mr. Thain says the issue of 'too big to fail' has still not been resolved five years after the tumultuous events that set off the financial crisis.
U.S. markets have taken a well-documented ride since the financial crisis bloomed in 2008. Less well understood are changes in segments within some of those critical markets — housing, jobs, stocks and the federal government’s investments. Track some of these shifts over time.

This year, Mr. Porter reversed course. Gastar borrowed $200 million in the junk-bond market to acquire oil wells in Oklahoma. It offered an 8.625% interest rate on the bond, which investors eagerly grabbed. The money fueled quick growth.

Five years after excessive debt propelled a housing-market collapse into a financial crisis and recession, similar bets are being placed across the U.S. The crisis ignited on Sept. 15, 2008, when investment bank Lehman Brothers collapsed under a mountain of highly leveraged mortgage debt. Despite a government bailout of financial firms that totaled hundreds of billions of dollars, 8.8 million jobs and $19.2 trillion in household wealth were lost.

The conventional wisdom has been that Americans learned an important lesson—that you shouldn’t take a loan just because one is available. Banks, companies and consumers aggressively dialed back borrowing in what was dubbed “the great deleveraging.”

But some experts say the deleveraging is over and releveraging is well under way, with corporate borrowers taking new loans hand over fist from investors hungry for higher returns.

"Leverage is getting back to where it was precrisis," said Christina Padgett, head of leveraged finance research at Moody's Investors Service. "After the crisis, companies were behaving more conservatively and lowering their debt."
Unlike the dark days of the financial crisis, banks are well-capitalized and more transparent. Mortgages remain hard to get for all but the most qualified home buyers. The groups dialing up risk and debt these days are mostly companies but also a growing segment of individual investors and borrowers.

Economists and analysts aren't flashing warning signs. They say responsible borrowing, lending and investing are needed to get the U.S. economy to full strength.

Total corporate-bond debt has grown to nearly $6 trillion, up 59% since 2007, the year before the financial crisis, according to the Federal Reserve.

Low interest rates are spurring records. Verizon Communications Inc. VZ -0.30% plans next week to issue $25 billion of bonds to finance an acquisition, which would eclipse the $17 billion corporate-bond record Apple Inc. AAPL -0.69% set in April. On Wednesday, Sprint S -2.56% issued $6.5 billion of bonds, the largest corporate offering rated below investment grade, according to Dealogic.

This new wave of borrowing comes during a period of tepid economic growth. As a result, corporate leverage—a measure of financial risk that compares debt to earnings—has returned to precrisis levels. Leverage by companies rated investment grade has risen 20% since 2010 and is now 1.51 times earnings, about 6% higher than in 2008, according to J.P. Morgan Chase JPM +0.46% & Co.

This latest risk-taking is, in part, by design. The Fed has kept interest rates near zero for years in hopes of stimulating the U.S. economy. Rising debt and leverage are signs of renewed market confidence.

But analysts are on the watch for early signs of trouble among high-return, high-risk investments. Before the crisis, in 2007, junk bonds made up 17% of the corporate bonds sold in the U.S., according to Dealogic. This year, they were a quarter of the total. Most companies with credit ratings below investment grade are especially vulnerable to rising interest rates because they typically must refinance debt because they lack the cash to retire it.
“Many companies are repeating some of the mistakes of the past,” by taking on too much debt, said Edward Altman, a New York University business school professor and the creator of a well-known tool for measuring corporate health, called the Z-score.

Mr. Altman said his latest forecast, which measures the probability of corporate defaults, showed overall corporate health was “no better than it was in 2007 and by some measures worse.” The median scores, which measure corporate financial health by analyzing a combination of liquidity, earnings, solvency and stock market valuations, were 4% lower for companies rated “junk” in 2012 than in 2007.

U.S. companies have built up cash reserves since 2009 but the trouble is that they are taking on debt at an even faster pace, said Eric Beinstein, a credit strategist at J.P. Morgan.

Companies have stepped up borrowing even as the growth rate of corporate profits has dropped from 39% in 2010 to 8% in 2012 and 3.9% in the first half of 2013, according to Moody's Investors Service.

At the same time, corporate debt levels have moved in the opposite direction: the expansion rate has moved from negative 1% in 2010 to 7.3% in 2012 and 7.9% in the first quarter of this year, according to Moody's.

The borrowing, to a large extent, is driven by investor demand. Big and small investors, unable to get better returns in more traditional money-market accounts and U.S. Treasurys, are drawn to the higher yields of riskier securities and other alternative investments.
Many people are chasing higher returns with margin loans that use investment portfolios as collateral. Margin debt reached a record $384 billion earlier this year, up 29% from 2012 and slightly more than the previous high set in 2008.

Gerald Schatz of Fort Washington, Pa., discovered a couple of years ago he could use the Fed’s low rates in his favor. After borrowing $500,000 on margin at 1.6% from his broker, the 78-year-old earned about 6% by investing the money in stocks and bonds.

To Mr. Schatz, the move was a no-brainer—as long as interest rates stayed low, stock prices rose and bond yields stayed high. “This just made so much sense to me,” said Mr. Schatz, president of a nonprofit group that operates child-care centers. “Leverage is just using cheap money. I don’t consider that to be a big risk.”

**What a Financial Crisis Looks Like: Photos**

![Protesters held signs behind Richard Fuld, chairman and chief executive of Lehman Brothers, as he took his seat to testify at a House Oversight and Government Reform Committee hearing on the causes and effects of the Lehman Brothers bankruptcy, in Washington, on Oct. 6, 2008.](https://example.com/protesters-signs-richard-fuld)

Debt and leverage can be profitable tools. The aim is to increase investment returns not by adding capital, but by using lent money to make market bets. If the return on those investments is greater than the cost of the debt, the strategy magnifies profits, as Mr. Schatz found. He said he added more than three percentage points to the returns on his portfolio with margin loans.

Leverage works in reverse when markets tumble, wiping out an investor’s capital more rapidly as prices fall. It also accelerates market downturns if many highly leveraged investors try to sell off securities to minimize losses, or indebted companies can’t refinance. That was one of the causes of the financial contagion that triggered the crisis five years ago, and why many firms and individuals reduced their leverage in the aftermath.

The biggest players in the U.S. financial system have been strengthened by new regulations and greater caution since the crisis. For instance, many large commercial banks that held tens of billions of dollars in bad mortgage securities and complex financial derivatives have generally rebuilt their balance sheets to include less leverage.

An important measure of bank health is the capital cushion they hold to absorb losses, known as Tier 1 capital. Under new requirements, U.S. banks’ Tier 1 capital, which declined from 11% in 2004 to a thin 9.8% in the third quarter of 2008, has risen to a 13%, according to SNL Financial.

U.S. household debt in the first quarter of 2013 fell $1.3 trillion, or 10%, since 2008, but that mostly reflects the decline in mortgage debt, according to the Federal Reserve Bank of New York. Stripping out mortgage-related loans, household borrowing has climbed 4% since 2008.
“The financial system is in much better shape,” said Craig Fehr, an investment strategist at Edward D. Jones & Co. L.P., the brokerage house. “The banks have recapitalized and capital standards are up. Consumer debt is also in better shape. Debt levels will rise from here, but that's good for growth. There's more demand for credit as the economy grows.”

But rising debt levels also expose some borrowers to potential losses and defaults. Rising interest rates, for example, can increase costs and jar markets. Many economists expect the Fed to begin winding down its $85 billion-a-month bond-buying program as early as this fall.

When interest rates rise, "somebody's going to take it on the chin," said Anders Maxwell, an investment banker at Peter J. Solomon Co. who specializes in corporate bankruptcies.

Many investment-grade corporate borrowers have locked in rates. But companies with credit ratings below investment grade had $2 trillion of junk bonds and leveraged loans outstanding in July, up from $1.3 trillion in 2008, according to S&P Capital IQ LCD. Many of those bonds will need to be refinanced, while the cost of the floating-rate loans will rise along with interest rates.

Even companies in risky industries have joined the borrowing binge. Check Into Cash Inc., a payday lender based in Cleveland, Tenn., was negotiating with banks to keep an approximately $125 million credit line open when loans were scarce in November 2008. Wells Fargo took over the
loan from National City Corp. but required Check Into Cash to keep its debt at such low levels that it "didn't allow us to grow," said W. Allan Jones, the owner and chief executive officer.

Payday lenders are facing a crackdown from state and federal authorities that might jeopardize future profits, but in June the company sold $165 million in high-yield bonds with a 12% interest rate. The terms allow Mr. Jones to pay himself a one-time dividend, as well as make acquisitions so the company can diversify into other kinds of loans—for example, using a client's car as collateral.

The bonds "may or may not be a good decision" for the company, Mr. Jones said, but the money was too good to pass up. "We've been waiting since 2009" for a chance to borrow, he said, "and I just got tired of waiting." He declined to specify the size of the dividend he received.

On Main Street, there are also pockets of rising debt, including growth in auto loans and student loans. While delinquencies for car buyers are low, the average credit score for people borrowing to buy new vehicles fell for each of the past four years, according to Experian.

Student loans, up 71% over the past five years, are approaching $1.2 trillion; in March last year, a third of the riskiest loans were more than 90 days past due, up from 24% in 2007, according to TransUnion LLC.

Small investors are increasingly partners in the corporate-borrowing surge. In 2008, mutual funds held, on average, 17% of the bonds and 3% of the loans made to junk-grade companies, according to Bank of America. Today, they own about 26% of the bonds and 19% of the loans.

The demand is part of a major shift by investors seeking higher yields. Assets in mutual funds and exchange-traded funds that invest in junk bonds have grown to $285 billion in July from $92 billion at the end of 2008, according to Morningstar. Investment in leveraged-equity exchange-traded funds, which buy stocks with borrowed cash, exceeded 2008 levels for the first time this year, hitting $12.2 billion in July, Morningstar found.

One potential of higher interest rates is a jolt to bonds and other investments exposed to highly leveraged companies. In June, after comments by Fed chairman Ben Bernanke led to a selloff in those securities, one investment fund that buys debt in highly leveraged companies, Apollo Investment Corp., AlNV -0.25% tumbled more than 16% before stabilizing. In an August investor presentation, Apollo stated it had prepared for rising rates by putting one-third of its income-bearing investments in floating-rate debt.

Even some big players on Wall Street are showing caution. This spring, J.P. Morgan passed up one of the biggest investment banking paydays of the year—raising the money for Bain Capital LLC and Golden Gate Capital's $6.9 billion acquisition of BMC Software Inc. BMC +0.05%

J.P. Morgan initially bid for the deal then balked when buyers asked that the bank commit to providing the loans for as long as nine months, exceeding the current norm for such leveraged deals, people familiar with the matter said.

Banks have generally refused, until recently, to make loan commitments exceeding six months for fear of being stuck with unwanted debt. When markets shut down in 2008, banks were saddled with loans worth more than $100 billion and no buyers.

Bain and Golden Gate quickly found other banks to provide the loans, as well as the investors to buy a large issue of high-yield "junk" bonds. J.P. Morgan and BMC declined to comment.

Leverage always appears under control until circumstances conspire to turn it against borrowers, say analysts, bankers and investors.
Mr. Porter, the Gastar chief executive, doesn't expect that to happen. The company reported a net loss of $161 million in 2012, and recently said that its long-term debt had doubled to $195 million, from $98 million at the end of 2012.

But the Houston-based company reported net income of $52 million in the first half of the year and, Mr. Porter said, oil production was up and he expected growth to accelerate with the new Oklahoma wells. He plans to refinance his bond before it comes due in 2018.

Debt is no longer a scary word, said Mr. Schatz, who admitted he ran into resistance at home for borrowing against his investment portfolio.

"My wife just didn't want to do it at all," said Mr. Schatz. "What are you doing, Jerry?" she asked."

Mr. Schatz said he analyzed his bet carefully, focusing on the cheap borrowing rate, as well as the loan size, which was modest relative to his portfolio.

"I never did anything like that before," he said. "I wouldn't have bought a lottery ticket. But this is different now."

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