

Strategy

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The End of an Era

The Impact of GE Capital Divestiture on the Short-term Debt Market

Abstract

The GE announcement should be a positive credit event for creditors and bondholders. The divestiture is an event that has been seven years in the making and it will result in a significant reduction of commercial paper outstanding, especially for the direct issue CP market. Short-term corporate bond supply also will suffer. As higher quality issuers exit, managing liquidity in cash portfolios becomes more challenging.

Introduction

For decades, General Electric (GE) has been a household name for most of us, not just because of the many GE products that we use every day, but also for the steady and widespread level of corporate borrowing that has been found in corporate treasury portfolios via money market funds, separately managed accounts and other liquidity vehicles. General Electric is a hybrid corporate borrower that straddles the industrial and finance sectors, and its recent decision to exit most of its finance business signifies the end of an era with meaningful implications for the short-term debt market.

Given GE's status as a widely-held, highly rated, non-financial issuer, we'd like to update our readers on the company's strategic plans and the likely impact of those on its creditworthiness. More importantly, we also like to discuss the implications for capital markets, particularly with respect to supply and liquidity issues in the short-term corporate debt space.

The End that Began Seven Years Ago

On April 10, 2015, General Electric revealed its plan to divest most of the assets in its General Electric Capital Corp. (GE Capital) unit¹. Of \$500 billion assets (\$363 billion after netting of cash and deposits), GE plans on keeping about \$90 billion to finance "verticals" related to its industrial businesses. Earnings contribution from the finance unit will fall to 10%, compared to 42% at the end of 2014. The firm expects the entire process of asset disposition to take approximately twenty-four months.

The GE announcement, while surprising to some in the marketplace, was in many ways a long time in the making. Between the 1980's and the financial crisis of 2008, GE became well-known for relying on its finance arm for rapid profit growth from the parent's then gold-plated AAA credit ratings and cheap wholesale funding. Most of GE Capital's businesses, including subprime consumer lending, residential and commercial real estate, insurance, bond guaranties and international retail banking, were

¹ For more information on the GE announcement, please refer to the "April 10, 2015 GE Capital Investor Meeting" section of its investor relations website.

<http://www.ge.com/investor-relations/ir-events/ge-capital-investor-meeting-1>

not directly related to the parent company's core industrial segments. In 2007, GE Capital accounted for 57% of GE's operating earnings, according to the firm's Investor Day supplemental.

The subprime crisis arrived in 2007 and it quickly spiraled into the calamitous banking and financial markets crisis of 2008. After it received government funding assistance and it was forced to cut its corporate dividend, GECC became the industrial parent's albatross in terms of profitability, share performance, and investor sentiment. In 2013, GE Capital became the only industrial, wholesale-funded, non-bank systemically important financial institution (non-bank SIFI). The SIFI designation imposes strict and costly capital, liquidity and operational oversight requirement by a host of financial regulators led by the Federal Reserve.

Senior managers took initiatives to reduce exposures to wholesale funding as soon as the financial crisis subsided by scaling back commercial paper issuance, disposing of non-core financial assets and growing industrial businesses concurrently. The SIFI designation in 2013 accelerated this strategic transformation. Despite these steps, GE Capital's current \$500 billion balance sheet remains big enough to make it the country's seventh-largest bank. The current favorable environment for financial asset prices provided an opportunity to slash the unit's earnings contribution target from 25% to 10%, and to work towards removal of the SIFI designation.

Strengthening Credit Profile

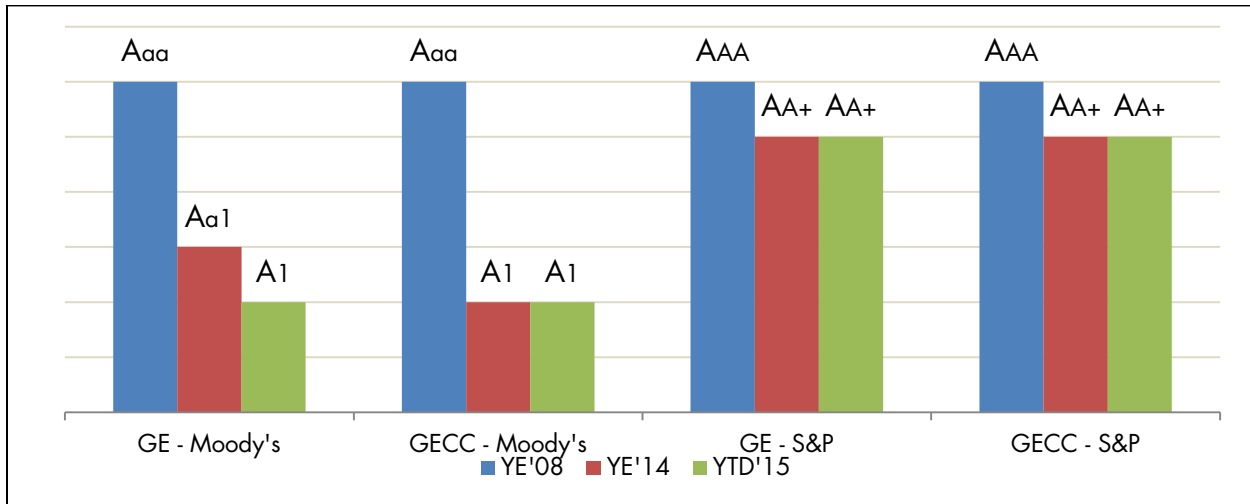
We think that the strategic shift to further integrate GE Capital into GE's core growth areas of aviation, healthcare and energy is credit positive. All else being equal, creditors and bondholders of GECC should welcome this new development, in our opinion.

Following GE's announcement, Moody's reduced the Aa3 rating on the parent's debt by one notch to A1 to match GE Capital's rating and it left both with a stable outlook. Moody's ratings decision was driven in part by GE's shareholder-friendly dividend policies and by the reduction of GE Capital's earnings capacity. Standard and Poor's, the other major rating agency, affirmed its AA+ rating on both entities, also with a stable outlook.

For much of the last two decades, bond investors have had lingering concerns about the possible negative credit implications that could stem from GE Capital's potential separation from its parent. These concerns escalated over the years as the finance subsidiary became less of a "captive" finance arm of the parent and more of an independent diversified financial firm. Even though GE has a "maintenance agreement" with GE Capital to help keep the finance arm's cash earnings above 1.1 times of its interest expenses, it did not have an explicit debt guarantee. Thus, market perception and bond spreads placed GECC's credit strength at a level somewhat lower than that of the industrial parent. After the financial crisis, credit rating agency Moody's Investor Services downgraded GE Capital's debt rating below that of GE, the parent, adding to the perception of credit differentiation.

As part of its strategic plan, GE replaces the former income maintenance agreement with a full, unconditional and irrevocable guarantee. This change applies to outstanding senior and subordinated bonds as well as to outstanding commercial paper issuance. In addition, management will merge GE Capital into GE and create a new intermediate holding company for financial businesses.

Figure 1: Credit Ratings History (Year-end 2008, 2014 and Year-to-date 2015)



Source: Bloomberg

Better Business Model: Moody's negative ratings action notwithstanding, holders of GE Capital debt should view the latest development as credit positive. The debt guarantee and the merger of the two corporate entities have removed a major source of uncertainty for market participants. The remaining "verticals" finance business for the firm's industrial segments make more strategic and credit sense than did a large commercial bank cloaked under an industrial cover. Stable business structure and multiple touch points with the same clients should contribute to a stronger credit profile over time.

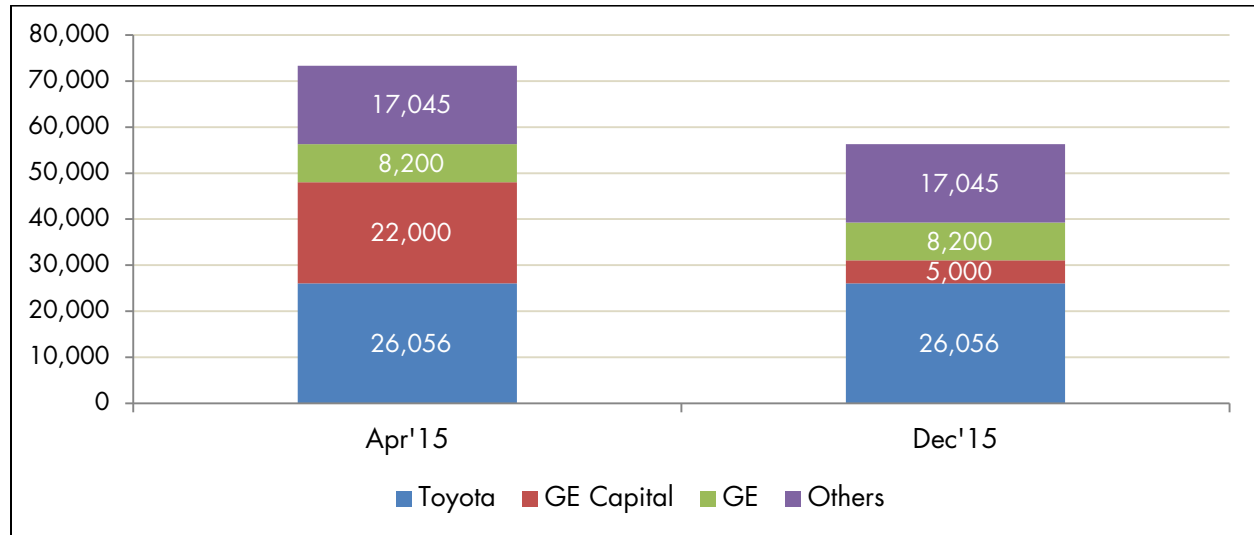
Stronger Funding Profile: Another benefit of a smaller GE Capital is a vast reduction in its wholesale funding needs, which proved difficult and unpredictable to obtain during stormy periods. Although Moody's cited lower earnings capacity as part of its rating decision, the company's future debt financing needs will also be reduced in the future along with related financing costs. As the company disclosed, GE does not plan to issue debt for at least five years, during which period its net debt outstanding will drop from \$274 billion to an estimated \$70 billion in 2019. Its liquidity needs, likewise, will drop from \$76 billion to \$20 billion. A less leveraged firm with lower dependence on the capital markets leads to a stronger credit profile.

Lower Regulatory Costs: Lastly, the expected removal of the non-bank SIFI designation should contribute to more streamlined operations and less operational and regulatory costs. While we typically view stricter regulatory capital and liquidity requirements as a benefit to bondholders, recent financial results and financial executives' commentaries point to burdensome compliance challenges and management distraction in addition to business restrictions and compliance costs. GE is entering into uncharted territory as a non-financial firm under the supervision of the Federal Reserve and other financial authorities. The removal of the SIFI designation should enable management to focus on running the business of providing credit to its industrial customers. We believe this development will lead to a strong credit profile.

Supply Drain from the Cash Market

As much as GE's divestiture may be a positive credit event, it also means that the available pool of highly rated and liquid corporate debt will shrink further in size. New financial regulations and issuer rating downgrades already present challenging supply-demand imbalances in the cash market. GE Capital's commercial paper program, down from \$100 billion in 2008 to \$25 billion in 2014, will further decline to \$5 billion by the end of this year for a total reduction of 95% from peak to trough.

Figure 2: Direct CP Issuers (Current and Pro Forma in \$millions)



Source: Bloomberg

Figure 2 provides a pro forma illustration of GE’s impact on the direct issue CP market. As of April 24, 2015, the combined GE and GECC entity is the largest direct CP issuer, representing 41% of the total outstanding. Assuming that GE Capital’s balance is reduced from \$22 billion on this day to \$5 billion by year-end, and holding GE’s \$8.2 billion and the rest of the market’s balances constant, the direct CP issuers market will shrink by \$17 billion, or 23%, in the next eight months.

Likewise, when using the Federal Reserve’s CP outstanding data of \$984 billion as of March 31, the combined GE program of \$30.2 billion currently represents 3.1% of the entire CP market. Come year-end, their presence will be cut by more than half to 1.4%.

The supply drain is significant not only in the money markets which are dominated by money market funds, but also in the short-duration corporate bond space. With the expected downsizing of its balance sheet, GE does not plan to have any net new term debt issuance for the next five years, thus cutting off most their new issues pipeline. As times marches on, GE Capital debt available to short-duration corporate bond buyers will also dwindle, reducing net supply.

Figure 3: Largest Corporate Issuers in Merrill Lynch 1-3 Corporate (A-rated and higher) Index

Rank	Issuer	Par Value	% of Index
1	JPM	29,430	4.5%
2	BAC	25,698	3.9%
3	WFC	23,147	3.5%
4	GE	22,275	3.4%
5	C	19,924	3.0%
6	MS	14,567	2.2%
7	GS	12,850	2.0%
8	AXP	12,550	1.9%
9	IBM	9,500	1.4%
10	TOYOTA	9,050	1.4%

Source: BAML Global Indices from Bloomberg as of April 23, 2015

Figure 3 shows that, as of April 23, 2015, GE is the fourth largest corporate issuer of one-to-three-year (remaining) maturities among issuers with credit ratings of A- or higher. In the next five years, one should expect GE's 3.4% representation in the corporate index to drop substantially.

Portfolio Implications

We view GE's planned divestiture with mixed feelings. On the one hand, we are comforted by the fact that the asset reduction of GE Capital and the full debt guarantee by the parent have removed significant credit uncertainties and improved the credit profile of the combined company. On the other hand, the expected reduction of GE Capital's short-term debt issuance adds to the already acute supply shortage for the cash investment community.

In terms of portfolio implications, we expect strong credit performance in GE debt. Despite Moody's negative ratings action, we remain comfortable with our portfolio holdings and look to add exposure when opportunity allows, as supply will become scarcer with the passage of time. We also will continue to monitor GE's shareholder-friendly activities, as we do with other large corporate issues.

We think that the negative supply impact on short-duration portfolios will be tempered by two factors. News reports suggest that GE is in advance talks with other high grade issuers including Wells Fargo. If a significant portion of its disposed assets end up in the hands of other high grade credits, more issuance may come from these entities. The second mitigating factor comes from the pending money market fund reform which will take effect in October 2016. As some investors switch from prime funds to government funds, demand for corporate paper may slack off to alleviate some of the market imbalances.

We should also caution that execution risk remains for GE as it attempts to dispose of its approximate \$170 billion of U.S. and international assets not already spoken for while the capital markets remain accommodative to asset prices. We believe GE will emerge a stronger company in two years, but the timing of several milestone events, including the sales of specific business lines and the de-designation of the SIFI status, still warrant close tracking of its progress.

In the final analysis, cash investors should be aware that the exit of high quality issuers will result in incrementally less liquidity in the marketplace, accelerating a trend which has been worsening in recent years. One should think twice before sacrificing precious portfolio liquidity to pick up slightly higher yield in this low yield environment.

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