INSIGHT

VIEWPOINT

Leveraged Loan Market: The Best of Times and the Worst of Times

DREW SWEENEY | JULY 24, 2018

- The quality of loan capital structures have weakened.
- Leverage has increased and EBITDA addbacks, synergies and adjustments have become more and more creative.
- Maintenance covenants do not broadly exist in the loan market and credit agreement protections have been eroded.
- All this has occurred during a historic rate of growth for both private equity and the leveraged loan market.

Leveraged loans were born out of the large LBOs of the 1980s and have always been the preferred debt instrument in leveraged buyouts. Historically, private equity would look to acquire a company with stable cash flows, look to operate it more profitably, cut costs and pay down debt. Given that loans have little call protection and can be prepaid at any time – loans are the preferred debt instrument of any deleveraging capital structure.

We have seen a tremendous amount of growth in the loan market during the last eight years with the Credit Suisse Leveraged Loan Index (CS LLI) growing 82% since December 2010. Clearly there has been a lot of demand for floating rate senior secured debt. Part and parcel with loan growth has been the growth in private equity. Private equity raised $3 trillion in capital from 2012 through 2017, posting the strongest five-year stretch for fund-raising in its history. So with all this growth, one must return to the fundamental question: If the best of loans are made in the worst of times, is the converse true? Well, we will endeavor to take a peek at what is taking place in the senior, secured floating-rate loan market and see if some of the pillars of what makes a loan a loan are being eroded.

Private equity fundraising has contributed to a more competitive bidding process, higher purchase price multiples and consequently, higher leverage.

Drew Sweeney
Senior Vice President
Fixed Income

Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firm's overall investment strategy. Prior to Bradford & Marzec, Mr. Sweeney worked for Macquarie Group (fka Four Corners Capital Management) in Los Angeles, where he managed both bank loan and high yield bond investments. Prior to Four Corners, he evaluated leverage loan and bond opportunities for Columbia Management (Ameriprise Financial, Inc.). He also worked as an Analyst with ING Capital Advisors and as a member of the investment banking team at First Union Securities where he gained additional experience in underwriting, structuring and syndicating leveraged transactions. Drew holds an MBA from the University of North Carolina Kenan-Flagler Business School and a BS from Rutgers University.

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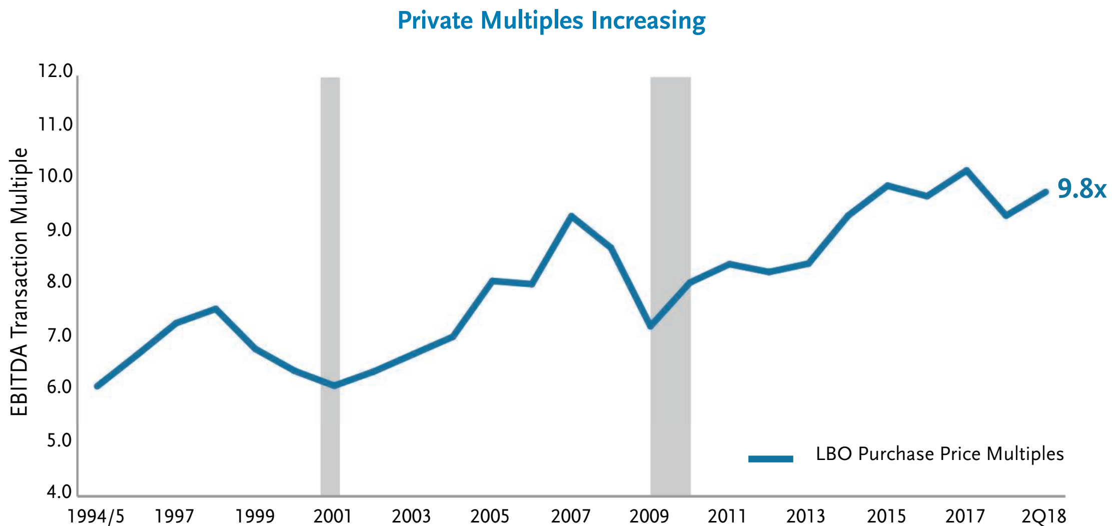
Private Multiples Increasing

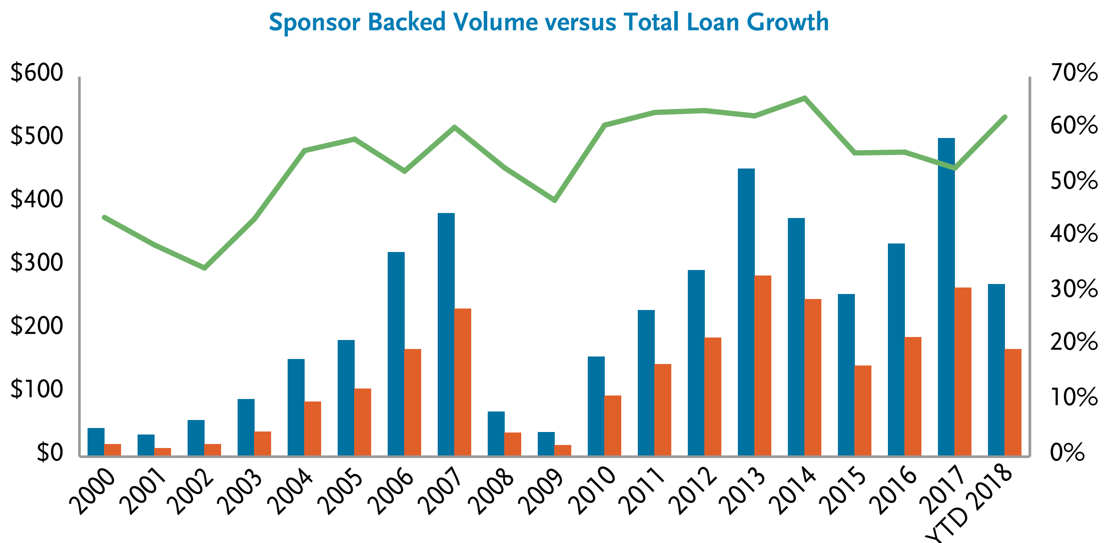


Source: S&P LCD

Given the need for private equity to pay higher acquisition multiples it is probably a safe assumption that significant multiple expansion from purchase to sale will be difficult for sponsors to achieve. And although it might be difficult, sponsors still need to generate a return for their investors. One creative way to create a return would be to move value from senior parts of the capital structure to more junior parts of the capital structure. Private equity sponsors have taken a targeted approach at weakening traditional loan terms by removing amortization and by reducing, watering down and outright removing loan covenants. Although private equity drove the initial weakening of loan terms, these lower standards have become pervasive.

When looking at new annual institutional issuance a few items stand out. Sponsor-backed transactions have dominated the leveraged loan landscape for the last 18 years. While LBOs as a percentage of the market hit a low of 35% in 2002, they are now responsible of 63% of all volume.

Sponsor Backed Volume versus Total Loan Growth

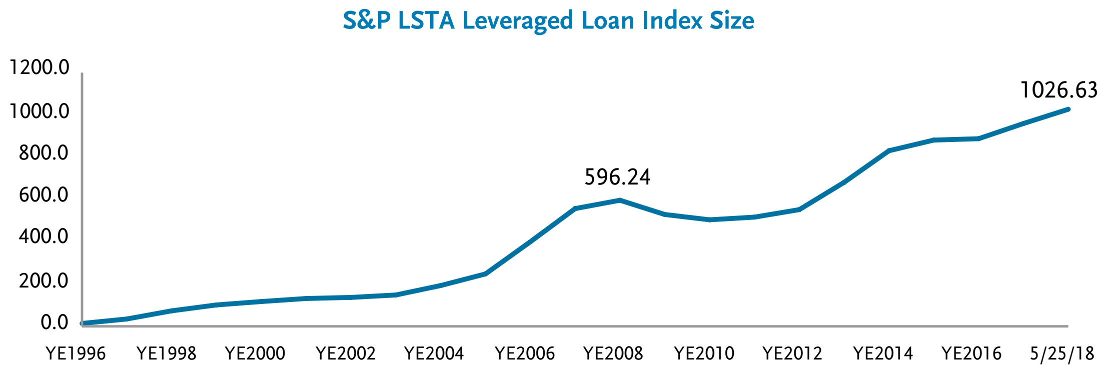


Source: S&P Global Market Intelligence

Leveraged Loan Market: The Best of Times and the Worst of Times

Not only has private equity grown as a percentage of issuance to over 60% of transactions in 2018, it has consistently represented 50%-60% of the institutional loan market during the largest issuance period in loan market history (post the global financial crisis).

S&P LSTA Leveraged Loan Index Size



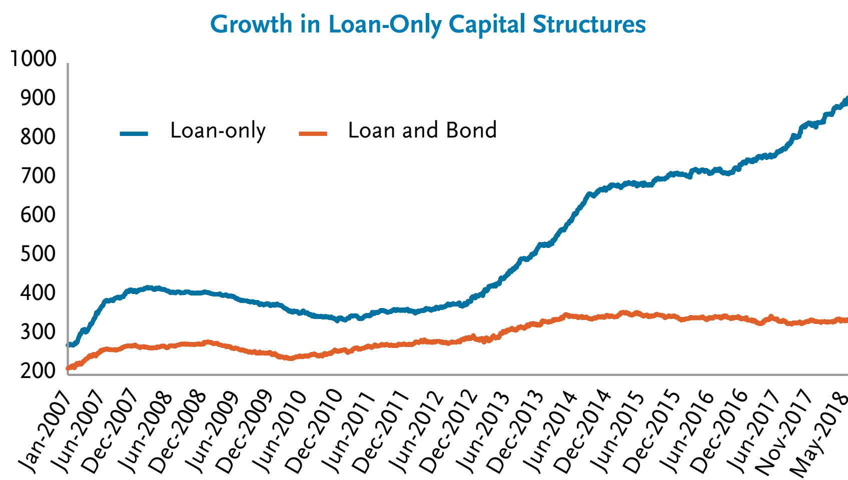
Source: S&P Global Market Intelligence

The S&P Leveraged Loan Index (S&P LLI) has doubled in size to more than $1.0 trillion since 2010, driven largely by private equity transactions. At the same time, the number of participants buying loans has also grown in an investor base consisting of banks and crossover investors (both investment grade and high yield accounts) as well as floating rate funds, separate accounts, hedge funds and CLOs. S&P Global Market Intelligence has recorded nearly 300 separate institutions that committed to three or more deals or received $10 million or more in estimated allocations. This is not a comprehensive list and would not even include term loan B demand from banks but it does highlight the possible number of participants in any one transaction. In the early 2000s, banks syndicating a transaction would have likely reached out to 50 or 60 institutional accounts, including banks looking to buy term loan B paper. A private equity sponsor singularly focused on one deal has the upper hand in negotiating documents with disparate group loan investors, which are focused on investing in hundreds of deals. Indeed, this basic logic seems to hold true when looking at the persistent erosion of credit agreement quality.

What else is new to the market?

We need look no further than the growth in bank-loan-only capital structures to understand that there has been overwhelming demand for bank-loan paper. JP Morgan recently highlighted that loan-only issuers have grown from 403 at the beginning of 2013 to 911 today, representing growth of 126%. This compares to modest growth among loan-and-bond issuers from 291 to 341, a 17% increase.

Growth in Loan-Only Capital Structures



Source: JPM

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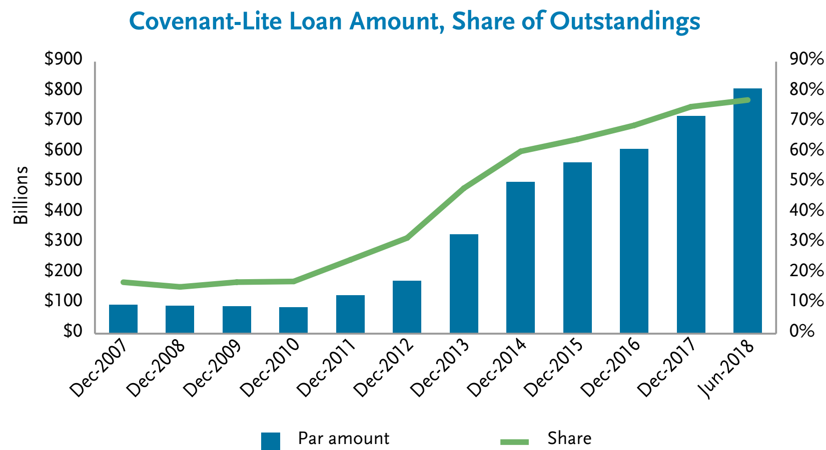
A lot of press has focused on covenant-lite loans versus loans with covenants, which have grown as a percentage of the market since the global financial crisis. This is not entirely new information but is one more piece in assembling our mosaic of credit quality.

Covenant-Lite Loan Amount, Share of Outstandings



Source: S&P/LSTA Leveraged Loan Index; LCD, an offering of S&P Global Market Intelligence

To reiterate some of the points above: The market is somewhere between 80% and100% larger than it was in 2010, loan-only capital structures are pervasive and covenant-lite loans are ubiquitous.

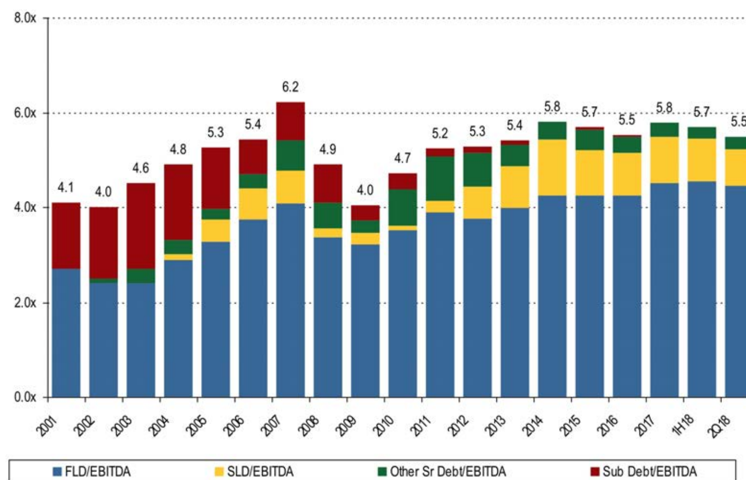
Is there anything else new?

Yes, as a matter of fact senior and total leverage is up and the number of EBITDA adjustments post the global financial crisis has grown dramatically.

Leverage for LBOs has hit the highest level since 2007 and is up nearly one-turn since 2010.

Average Debt Multiples of Large Corporate LBO Loans

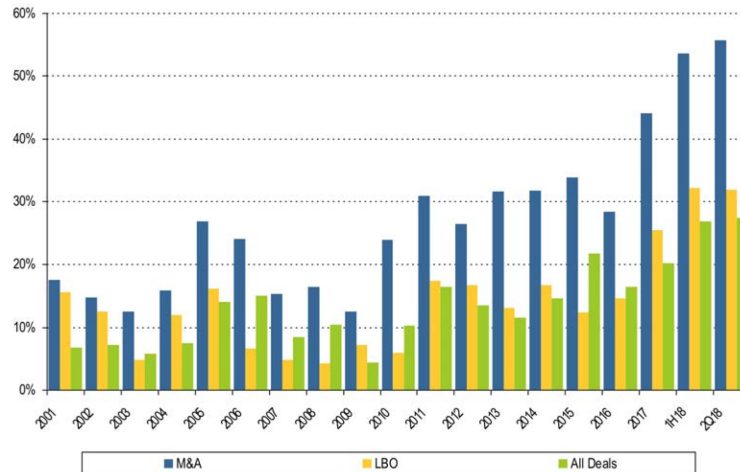
(Media and telecom loans excluded prior to 2011.
EBITDA adjusted for prospective cost savings or synergies)



Source: S&P Global Market Intelligence

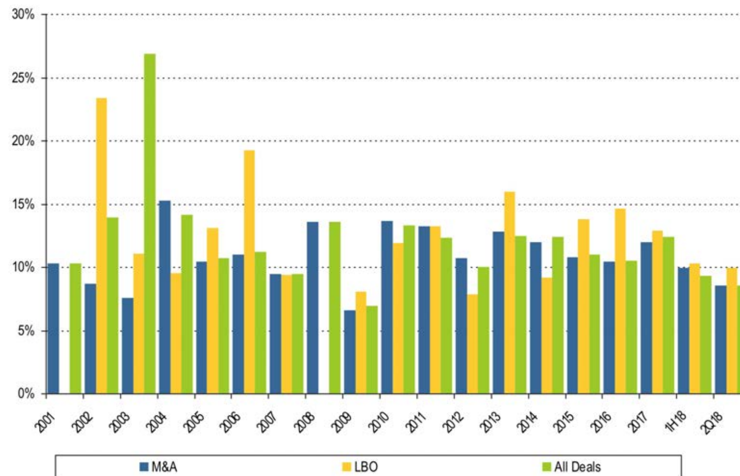
While EBITDA adjustments appear to be in line with historical levels, the percentage of deals using EBITDA addbacks has increased consistently.

Transactions with EBITDA Adjustments



Source: S&P Global Market Intelligence

Percentage of Adjustments to EBITDA



Source: S&P Global Market Intelligence

Therefore, leverage is growing while EBITDA adjustments are material. The real consequence is quite simple. Some deals are over-levered and if there is either an idiosyncratic event impacting a borrower or a more systemic event like a recession, there is little room for error.

From our vantage point, it feels like EBITDA adjustments have grown more than the chart above would imply. We have seen several deals in the last 12 months where we view adjustments approximately 50%-100% of the total size of the original EBITDA rather the ~10% highlighted in the chart above.

There are two examples we will highlight below on a no names basis.

Example 1

- The first deal operates in the pharmaceutical industry and completed a large acquisition last year.
- The adjusted EBITDA was 40% larger than EBITDA and the final marketed EBITDA was 90% greater than the original EBITDA.
- While we could get comfortable with some of the adjustments – we felt like the marketed EBITDA was borderline absurd.
- The use of proceeds included a significant dividend.
- The investment bank leading the transaction marketed the deal with 4.8x senior secured leveraged and 7.0x total leverage. We viewed the deal as closer to 6.1x senior and 8.8x total.

Example 2

- The second deal operates in a health care service industry. EBITDA addbacks used in this deal were creative to say the least.
- Basically, in this business model, the company is required to open offices. When they open an office they can addback those costs. On one hand, we understand that concept. But the sponsor doesn't plan to have this be a one-time office opening. They intend to grow the business and open many offices every year. So that really should not be added back to EBITDA since is normal course of business.
- The company is also permitted to run-rate the performance a new office and addback EBITDA equivalent of a mature office's EBITDA. Huh? So they addback the amount to open an office and they add back the difference between actual performance and whatever they expect future performance to be?
- Now here is the really special part. If the company opens an office and it fails; well, they can add that back too. Simply put, every office is assumed to workout out but if it doesn't - those expenses are added back to EBITDA.
- EBITDA to adjusted EBITDA was slightly greater than 100% but pro forma adjusted EBITDA was three times greater than EBITDA.
- We believed that adjusted leverage for the deal was 6.3x secured and 8.2x total, where the investment bank marketed the deal 4.1x and 5.1x.

What about the credit agreements?

The quality of credit agreements has also eroded. Restricted payments covenants, which limit dividends, share buybacks, and other returns paid to shareholders by mandating that such payments not exceed a certain level, have been loosened dramatically. The ability of borrowers to un-restrict entities in the borrower group has become common. Cash is often not part of the collateral and borrowers can often move cash out of the borrower group to unrestricted entities. All-in-all, there has been a very targeted approach to weaken lenders' ability not only to claw back the very money we have loaned to borrowers but also lay claim to the assets by which we are supposedly secured.

Looking forward – what does this all mean?

First, we should provide some context to the generally bleak picture we have painted above. Private equity has a long history of successful investment. Therefore, having an asset class such as loan aligned with private equity could be viewed as a positive. Furthermore, the businesses comprising the loan index today versus the businesses we saw 18 years ago are bigger, more diverse, more interesting and more often market share leaders versus the pool of available borrowers two decades ago. Purchase price multiples have grown but the equity tickets during the last 3.5 years have also grown.

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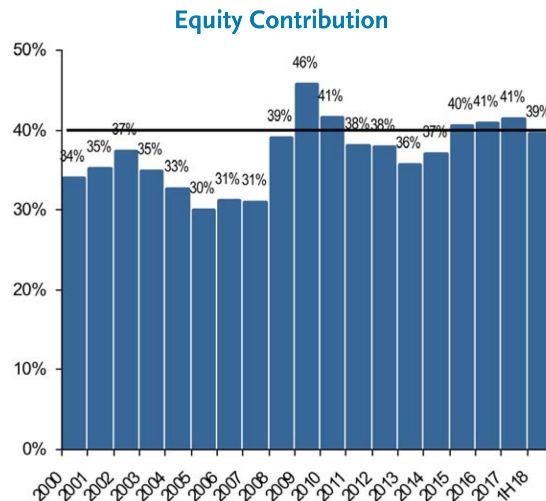
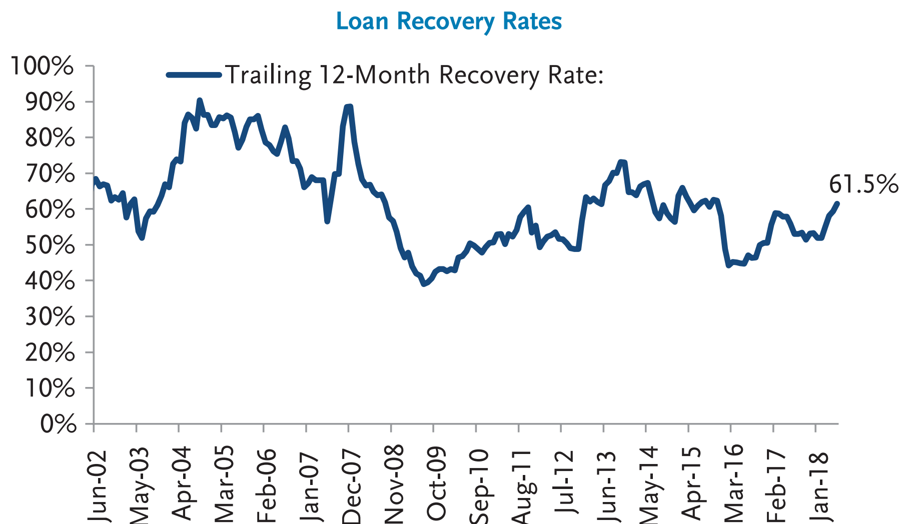


Source: S&P Global Market Intelligence

It should also be noted that we have operated in a period of low default rates and good earnings, which have allowed companies to push out maturities, lower debt costs and pay down debt. Finally, managers have a far greater ability to pick and choose what they want to own in the bank loan universe as the selection of assets is much wider than two decades prior. All these are very good facts and underpin why one would want to invest in loans.

Unfortunately, a lot of these positives are somewhat offset by the bad fact that many companies want to metaphorically have the right to play three-card Monte with the very assets they purchased with the loan proceeds. We believe that net-net, these actions will result in lower recoveries. Trying to put some context around recoveries, we compare first lien loans to high yield bonds. Historically, first-lien bank loan recoveries have been closer to 70% and high yield bond recoveries have been closer to 40%. High yield borrowers generally are not first liens, generally don't benefit from financial maintenance covenants and they generally have little if any debt subordination below them. Loans do still benefit from some protections even if they are not as strong as protections the market saw 20 years ago. As a result, we would assume recoveries from this vintage of deals will be lower than 70% but much higher than 40%. Indeed, that is how recoveries have behaved in the last sixyears, averaging something closer to a 60% recovery.



Source: Credit Suisse

Recap

Private equity groups have had explosive fund raising and the loan market has had a commensurate level of robust growth. Broadly speaking, there are not only more loan-only capital structures but also the leveraged loan market has weaker covenants and higher leveraged multiples with more aggressive adjustments to EBITDA than at any point historically. This will create higher volatility and ultimately lower recoveries.

Credit selection and active management will be more important than at any time in the past. ■

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