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CREDIT MARKETS

Opportunistic Deals Lead the Leveraged Loan Market to a Strong Start in 2017

BY ALEXANDRA MARGOLIS

The U.S. leveraged loan market is off to a strong start in 2017, as borrower-friendly conditions fuel a surge of opportunistic transactions. Refinancings and repricings are the primary drivers of issuance in this market, continuing a trend from the fourth quarter of 2016. Rising interest rate expectations have prompted borrowers to return to the loan market for multiple repricings at the fastest pace since 2014. Investors are pouring into the asset class as the Federal Reserve has started raising interest rates and is seen hiking more this year.

Bankers and investors project U.S. mergers and acquisitions (M&A) activity to increase in 2017 as fiscal stimulus measures, corporate tax reform, deregulation and other policies supporting economic growth are expected to be implemented by President Donald Trump and the Republican-controlled Congress. A pro-growth environment and a stronger economy are seen by many bankers to lead to private equity buyouts that will generate higher new loan issuances and a robust overall loan market. For some market participants and analysts, however, geopolitical risks, trade protectionism, deportations, and the potential for volatility lead to more cautious expectations for deal activity.

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After a rough start caused by numerous factors, including a sharp decline in oil prices and concerns about economic growth, a recovery in commodity prices and accommodative fiscal policy helped the leveraged loan market achieve a strong year in 2016. U.S. leveraged loan issuance rose by almost 12 percent to $875 billion in total, which is the third highest year on record. Institutional loan issuance in 2016 totaled $421 billion, up 44 percent from $295 billion in 2015, driven by an 85 percent increase in refinancing volume to $221 billion. M&A leveraged loan volume, however, dropped by 18 percent last year to $270 billion. Total collateralized loan obligation (CLO) issuance of $71.7 billion for 2016 was down from $98.7 billion in 2015 but still exceeded many expectations for the year. The expectation of interest rate increases and the yield protection afforded by floating rate loans led to a reversal of activity for leveraged loan funds. Specifically, the $5.5 billion of outflows that occurred in the first half of 2016 was reversed, and leveraged loan funds ended the year with a net inflow of $7.8 billion, the first positive year since 2013.

With the refinancing and repricing wave accelerating into 2017, January was the busiest repricing month on record with total volume of $111 billion. February's repricings total was $58.3 billion, a drop from January but more than any monthly total in the fourth quarter of 2016. These opportunities to reduce loan spreads have arisen due to a shortage of new M&A deals and the unrelenting demand of retail investors. Also taking advantage of opportunistic conditions, private equity firms have paid themselves dividends via sponsored dividend recap issuance of $13.5 billion through February of this year. Institutional capital flowing into the loan market in search of higher returns also is providing repricing opportunities for the riskier second lien market, reducing the average yield on second lien loans to its lowest level since the second quarter of 2015.

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The supply/demand imbalance prevailing in the loan market since last summer has increased in 2017 relative to 2016, with demand overwhelming supply by $14.1 billion in January and by $8.1 billion in February. Through March 1, leveraged loan funds had 16 consecutive weeks of inflows totaling $15.9 billion, with 2017 inflow of $8.1 billion. Although CLO issuance was down in January, issuance picked up in February and total CLO issuance for January and February was $8.12 billion.

Attracted by the relatively higher yield of middle market loans, institutional leveraged loan investors are turning to the middle market to counter the repricing wave depressing yields in the broadly syndicated market. This quarter, the average yield on large corporate institutional term loans is 4.46 percent, compared to 5.88 percent for middle market term loans, according to Thomson Reuters LPC. This middle market yield premium is attracting demand from insurance companies, pension funds and other institutional investors seeking opportunities to generate greater yield.

The trailing 12-month loan default rate is at a 13-month low of 1.41 percent by principal amount through February, and loan portfolio managers have lowered their expectations for near-term default rates. The consensus estimate now predicts the 12-month trailing U.S. default rate by principal amount to end 2017 at 2.44 percent, according to LCD's latest survey. The recent wave of refinancings and resulting change in the maturity wall, together with a reduction in energy sector default candidates and the preponderance of covenant-lite loans, are cited by portfolio managers as reasons for loan defaults taking longer to occur, with the historic average of 3.1 percent not expected to be reached until 2018.

Interest Rates in Focus

The Federal Reserve raised interest rates in March for the second time in three months, signaling more vigilance as inflation approaches its target. The Federal Open Market Committee (FOMC) did not indicate any plan to accelerate the pace of monetary tightening, maintaining its outlook for two more rate hikes this year. Fed officials now project three more rate increases in 2018, with interest rates settling at their long-run average of 3 percent by the end of 2019, slightly sooner than they forecast in their December projections.

Economic forecasts released with the Fed's statement showed little change from those of the December policy meeting, forecasting the economy growing by 2.1 percent in 2017 and the unemployment rate by the end of this year at 4.5 percent. Maintaining language it had used in previous statements, the Fed stated that ''with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace.''

Recent data indicates the U.S. economy is growing steadily. According to a series of data releases in the first quarter on consumer confidence, jobs, manufacturing and non-manufacturing activity, the U.S. economy is enjoying consistent, broad-based growth. Consumer confidence rose in February to a 15-year high, with both the ''present situation'' and ''expectations'' indices increasing, according to the Conference Board Consumer Confidence Survey. After adding 227,000 jobs in January the economy added 235,000 jobs in February, far exceeding average estimates. The February ISM Manufacturing and Non-Manufacturing Indices of economic activity each increased beyond expectations in February. The Manufacturing Index jumped 1.7 points, exhibiting its strongest growth rate in composite activity since August of 2014. The Non-Manufacturing Index rose 1.1 points in February, its highest reading since October of 2015.

Complementing the positive data pointing to strong economic momentum, the Federal Reserve Bank of New York said its February survey of business leaders in the region's service sector reflected the outlook for future business activity rising to its highest level in more than a year. The stock market also is reaching new highs based on the combination of strong economic data and optimism that the Trump administration will bring business-friendly tax cuts, fiscal stimulus and deregulation. Of course, a failure of pro-growth policies to materialize in Washington, or a trade war or other disruptions, could halt business expansion and potentially slow the pace of interest rate hikes.

Libor has risen steadily over the past six months, with the three-month Libor rate now exceeding 1.0 percent, a noteworthy milestone because the vast majority of institutional loans have 1.0 percent Libor floors. As a result of three-month Libor surpassing the floor, interest payments tied to that reference rate are again correlated with the benchmark, a development welcomed by retail investors pouring into the asset class. Barring a dramatic increase in Libor, interest coverage levels (12-month trailing EBITDA divided by 12-month trailing interest expense) are not expected to tighten materially for many performing leveraged loan borrowers as interest coverage ratios are well above historical averages. Of course, coverage ratios could cause stress for lower-rated loan issuers.

Impact of Technicals on Terms

Borrowers and sponsors are using the supply/demand imbalance to obtain not only tighter spreads but also more aggressive terms in their deals, with several trends illustrating the recent erosion in terms. The covenant-lite share of the S&P/LSTA Leveraged Loan Index now stands at 68 percent of the loan index, the highest level on record. Market conditions being as issuer-favorable as they are, managers say that pushing back on even many of the most aggressive loan terms has been more challenging than usual this year, according to Covenant Review.

One example is the easing of typical requirements relating to incremental term loans. Traditionally, incremental term loans are not permitted to mature earlier or have a shorter weighted average life to maturity than the existing term loans. Top-tier sponsors in some recent deals have negotiated to exclude a specified amount of incremental term loans (including incremental equivalent debt) from these requirements, with the same exclusion sometimes applying to ratio debt, refinancing debt, extended debt and acquisition debt.

Deterioration also can be seen in the parameters of most favored nation (MFN) pricing protections under incremental loan provisions. The MFN permits only a limited increase in pricing (usually 50 basis points) for pari passu incremental term loans without requiring an interest rate increase for the existing term loans to eliminate the greater pricing differential. As a result of

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the current borrower-friendly market conditions, a few top-tier sponsored deals this year have closed with a 75 basis point differential triggering MFN protection instead of the typical 50 basis points. In addition, some deals have diminished the scope of MFN provisions by triggering MFN protection for incremental term loans incurred in reliance on only a specified portion of the incremental capacity -- either the free-and-clear portion or the ratio-based portion -- but not both. In some deals, MFN protection is not triggered for (i) incremental term loans incurred to finance a permitted acquisition or investment, (ii) incremental term loans that mature more than two years (sometimes one year) after the latest maturity date of the existing term loans, and/or (iii) a negotiated dollar amount of incremental term loans.

Borrowers and sponsors usually propose that MFN protection ''sunset'' after a specified time period (typically 12 or 18 months) from incurrence of the existing term loans. Lenders invariably push back on MFN sunsets during syndication, and more often than not succeed in eliminating them. Through mid-March, however, at least 12 loans reportedly cleared syndication with an MFN sunset intact.

In another sign of the issuer-favorable loan market, borrowers and sponsors have made more lenient use of EBITDA adjustments in new M&A loans in recent months. The average EBITDA adjustments represented 29 percent of initial pro forma EBITDA for M&A transactions between December and February, up from 22.4 percent in the 2016 fourth quarter, according to Covenant Review. In particular, the number of loans containing projected cost savings and synergies adjustments with higher caps or without any caps has increased over the past several months.

With refinancings and repricings dominating the leveraged loan market, lenders have become more flexible on new LBO deals. Average leverage on large and middle market LBOs has increased in the first quarter of this year to 6.5 times total debt to EBITDA, up from 6.1 times in the last quarter, according to Thomson Reuters LPC. This is the highest level since 2014, and several deals have closed with adjusted leverage over 7.0 times.

Term loans typically have six or 12 months of soft-call protection, requiring borrowers to pay a 1.0 percent premium if the loans are repriced during that period. For this reason, many borrowers hold off repricing their loans until call protection rolls off. In this market, however, some borrowers are willing to pay the soft-call premium to obtain the lower spread, highlighting the shift in market tone over the past several months. As a consequence, 12 months of soft-call protection has become increasingly less desirable for borrowers, and 2017 deals thus far on average have shorter soft-call protection periods than those in 2016.

Looking Ahead

President Trump's stated policy positions, including a massive infrastructure investment, are expected by many to strengthen the economy if they are enacted. It remains to be seen to what extent the president actually implements these policies and whether Congress approves the funding needed for them. Bankers believe the administration's policies will help infrastructure and energy-related sectors, while healthcare businesses could suffer if the Affordable Care Act is repealed. Deal-friendly Wall Street veterans comprise a large portion of President Trump's cabinet and bankers and investors expect a significant increase in M&A activity, which would drive substantial acquisition financing.

While capital markets have embraced the positive aspects of the Trump policies, and business confidence measures are pointing to heightened optimism, the difficulty of governing makes a concrete timeframe for policy changes uncertain. Disagreements between Trump and Republican leaders on tax reform, spending for infrastructure, and budget positions are increasing execution risks for enactment of a tax reform-driven fiscal stimulus. Similarly, repeal and replacement of the Affordable Care Act is encountering tremendous difficulties and could delay implementation of fiscal stimulus measures. The longer protracted uncertainty continues as to the direction of healthcare reform, the more of a damper it likely will have on deal activity in the healthcare sector.

One of the Trump administration's explicit goals is dismantling the regulatory framework that previous Democratic administrations enacted, including the repeal or significant reform of the Dodd-Frank Act. In particular, the administration has indicated its desire to remedy what it considers the disproportionate harm that Dodd-Frank causes to regional and community banks relative to larger banks. The president wants to incentivize increased lending by reducing regulatory burden, Republicans in Congress favor some form of regulatory rollback, and the Treasury Secretary has comprehensive knowledge of financial institutions and appears to be well-positioned to develop a regulatory reform agenda. It appears likely that certain core provisions of Dodd-Frank will be amended, such as in the way set forth in the Financial CHOICE Act proposed by Representative Jeb Hensarling (R-Texas), the chairman of the House Financial Services Committee. Approved by that committee last fall, the Financial CHOICE Act proposes significant changes to Dodd-Frank, including repeal of the Volcker Rule, structural changes to the Consumer Financial Protection Bureau to limit its authority, and an increase to the current $50 billion asset threshold at which banks are subject to enhanced supervision.

Enforcement of U.S. leveraged lending guidance could ease if regulators choose to be less rigorous under the Wall Street-friendly administration. In 2013, the Federal Reserve, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency (OCC) released updated leveraged lending guidance to reduce aggressive lending by banks to highly leveraged borrowers. Their concern was that highly leveraged lending was escalating while prudent lending practices were declining. The OCC recently expressed a moderated view of the systemic risk posed by U.S. leveraged lending, changing its characterization of leveraged lending to an ''issue warranting continued monitoring'' from a ''key risk,'' according to its semi-annual risk report for fall 2016 released in early January. The OCC noted that enforcement actions issued against banks had declined through the first half of 2016, ''reflecting overall improvement in banks' financial conditions and risk management practices.'' Whether or not relaxing enforcement of the guidance or other changes in the regulatory environment has much impact on the loan market is speculative, however, as banks might not necessarily materially alter their underwriting standards.

President Trump has promised corporate tax reform and, with Republican control of Congress, such reform is likely and has the potential to reshape capital markets. As economists and investors analyze the president's plan and the House Republicans' plan, attention is focusing on several related aspects that could dramatically alter how companies invest and fund themselves. The first is a corporate tax rate reduction from 35 percent to 20 percent (under the House plan) or 15 percent (under the Trump plan). To pay for those reductions, the House plan eliminates a key tax benefit associated with debt incurrence, namely the right to deduct interest payments from income. Related to this change is the right of companies to deduct the cost of capital investments in one year instead of depreciating them over time. The Trump plan offers companies the ability to elect to forfeit the interest deduction in exchange for being allowed to immediately deduct capital expenditures. For highly leveraged borrowers, however, removing the interest deduction would increase the cost of debt and likely curtail the issuance of debt by these companies. Another proposed tax reform, a one-time low transition tax on offshore earnings, could positively impact deal activity but reduce the need to borrow for some companies, thereby also impacting the debt markets.

Overall, the Republican tax reform proposals would benefit some companies and sectors and harm others, and a number of issues (including a controversial border adjustment tax on imports) remain to be resolved.

In general, bankers project leveraged loan issuance this year to be on par with 2016. In an optimistic scenario, however, 2017 leveraged loan issuance could be 10 to 15 percent higher, according to some analysts. Current projections of CLO issuance in 2017 range from $55 billion to $75 billion, although some bankers believe $80 billion to $100 billion is possible if market conditions remain positive. In particular, the CLO community is optimistic that risk retention rules could be either repealed or relaxed by the Republican-controlled Congress and the Trump administration. If risk retention were repealed by mid-2017, some bankers project that would have a material impact on the CLO market and significantly increase 2017 issuance.

According to a recent survey of the Loan Syndications and Trading Association (LSTA) board, comprised of twenty-four senior loan market professionals, the predominant view is that technicals will continue to have the largest impact on the loan market, citing this over other factors such as economic growth, the Trump administration and deregulation. With confidence in the strength of the economy high and expectations of interest rates rising this year, investor demand is showing no signs of abating. Repricings and refinancings are expected to dominate the loan market until an uptick in M&A brings new deals to the market to ease the supply/demand imbalance. Looking ahead, borrowers and sponsors likely will continue to have leverage in negotiating tight spreads and loose covenants unless and until the market's technicals shift.

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Sources for the data in this article are: S&P Capital IQ LCD (LCD), LevFin Insights, Covenant Review, Thomson Reuters LPC, and Moody's Analytics, Inc.

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