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## Turnaround Topics

By Mark Laber and John Yozzo[1]

# Default Surge on Hold as Leveraged Credit Markets Refuse to Buckle

**Mark Laber**
*FTI Consulting, Inc.*
*New York*

**Coordinating Editor**
**John Yozzo**
*FTI Consulting, Inc.*
*New York*

*Mark Laber is a senior managing director and John Yozzo is a managing director with FTI Consulting, Inc. in New York.*

It has been nearly a decade since the last default cycle was upon us, and restructuring professionals await the next one with nearly the same eagerness as a child waiting for Santa Claus on Christmas Eve. A decade between default cycles is a good, long time and there is increasing chatter that "we are due." This might be true strictly in terms of calendar time, but default cycles do not spontaneously occur and the ground conditions that have always preceded prior ones are not yet in place. Namely, distressed debt levels are exceedingly low and leveraged credit markets continue to be supportive of high risk borrowers, whose access to capital remains plentiful and affordable.

If you thought that an unexpected stock market correction, the return of volatility to equity markets, creeping interest rates, a hawkish-leaning Federal Reserve, the prospect of trade wars and escalating geopolitical tensions would be enough to rattle leveraged credit markets in the first quarter in 2018, well, you would be quite mistaken. Not only have corporate credit markets withstood these recent adverse developments, but there are new reasons to believe that they will continue to support high-risk credits for the foreseeable future barring a shock event. Despite repeated warnings from highly respected market-watchers regarding deteriorating lending standards, weakening lender protections and distorted risk/return prospects, leveraged credit markets continue to roar. Until this backdrop changes, it is hard to make the case that a substantial uptrend in default activity and bankruptcy filings is in the offing.

## How Did We Get Here?

In two letters: QE. In response to the Great Recession, the Federal Reserve implemented an aggressive monetary stimulus initiative commonly known as quantitative easing (QE), which is generally credited with resuscitating U.S. credit markets following a period of near dormancy in the midst of the financial crisis. Since the Lehman Brothers' bankruptcy, assets on the balance sheet of the U.S. central bank have increased nearly fourfold as a result of security purchases under QE. However, we are now embarking on a prolonged period of unwinding as the Fed slowly starts the process of reducing its $4.3 trillion balance sheet, which will entail rising interest rates and a less managed credit environment.

Nevertheless, the QE initiative was not without its share of detractors, who contended that it sowed the seeds of the next financial crisis. The primary criticism of this unprecedented monetary stimulus was that it would debase the dollar, discourage saving and ignite inflation due to its massive creation of money. Others were critical that the Fed kept interest rates too low for too long; QE officially ended in October 2014. The U.S. monetary base, which consists of currency in circulation plus reserve balances of U.S. banks with the Fed, has soared to $3.8 trillion currently from $833 billion a decade ago, an astounding annual growth rate of 16.4 percent, due primarily to increases in bank reserves resulting from Fed purchases of securities.

However, the dire predictions of QE critics have utterly failed to materialize nearly a decade later, with inflation remaining very tame and the dollar relatively strong. Were the skeptics entirely wrong? Traditional inflation — too much money chasing too few goods — has not occurred because QE's massive monetary expansion did not flood the consumer economy. Rather, it has largely remained within the institutional community and has sloshed around financial markets, where, arguably, too much money has been chasing high-risk borrowers and leveraged transactions.

1 The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc. or its management, subsidiaries, affiliates or other professionals.

Huge capital flows into corporate credit markets via bank loans, institutional lenders and business development companies, as well as the proliferation of private lending platforms, are a manifestation of QE, an unanticipated outcome that continues to encourage high risk tolerance and low pricing spreads and eroding traditional lender safeguards. Much like fluid dynamics, the money must flow somewhere. Fund managers cannot sit on dry powder indefinitely, even if they do not like what they see. This money must be put to work, and fund managers have strong financial incentives to do so.

The enormity of the private-debt asset class today — lending and other credit investing that occurs outside the traditional banking system and is exempt from federal banking regulation — is underappreciated. Preqin, a provider of private capital markets data, reports that assets under management (AUM) in global private debt funds exceed $630 billion, a majority in North America, with dry powder of $236 billion globally at year's end. Direct lending accounts for approximately a third of private debt AUM but accounted for one-half of new capital raised in 2017. Regulated banks have been losing market share in lending to private credit funds in recent years, giving rise to the term "bank replacement debt."

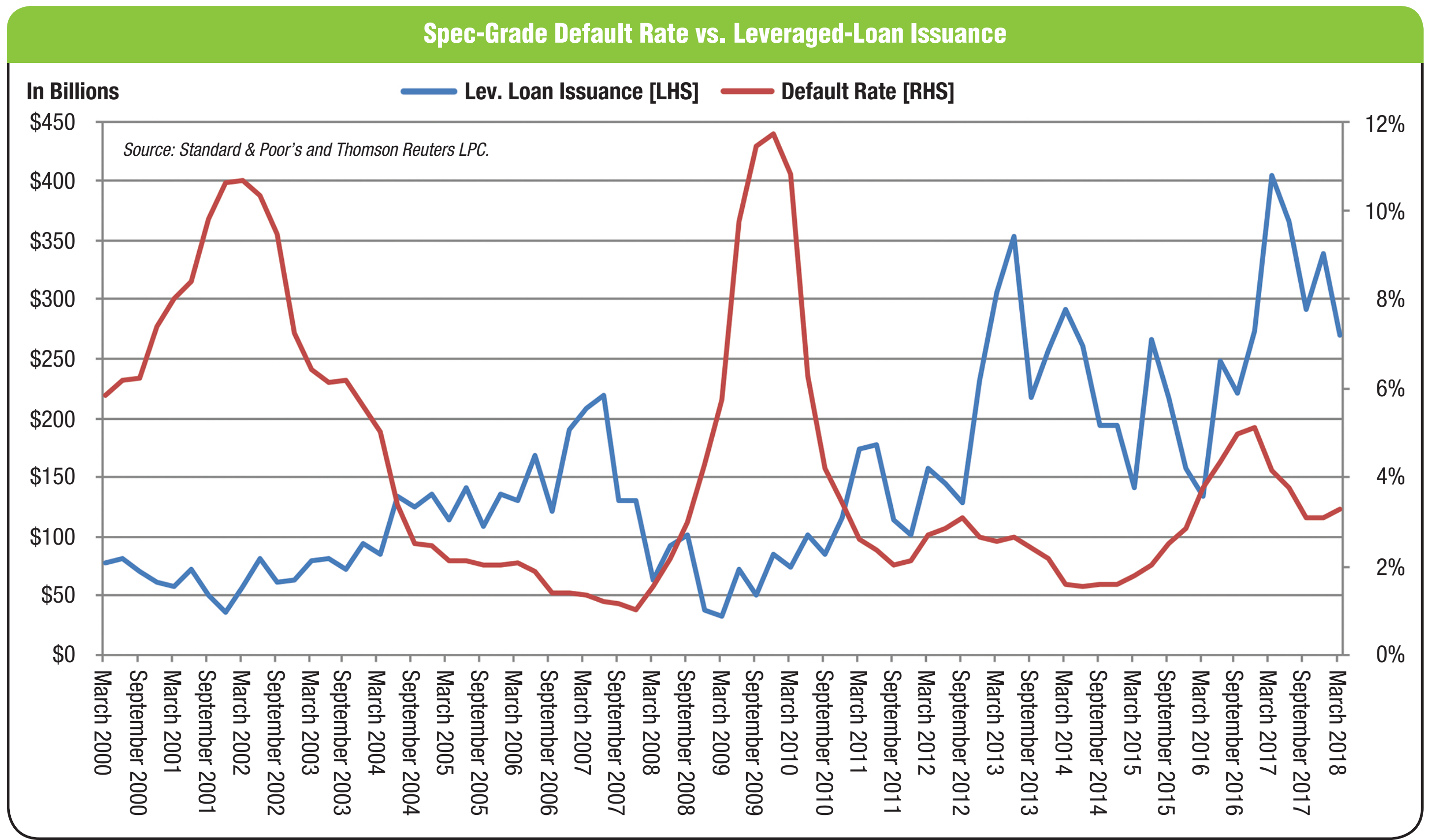
As the expectation of higher interest rates becomes embedded with investors, new money has recently rushed into the loan asset class, which is floating-rate-based, causing spreads to contract since late 2017 and offsetting some of the increase in LIBOR base rates. Even spreads on high-yield bonds, which are overwhelmingly fixed-rate, have remained mostly steady in 2018 as the 10-year Treasury rate hits 3 percent. It has been an impressive showing to date in 2018 amid a period of broader market turbulence.

Private equity sponsors remain a driving force behind leveraged lending volumes, with 2017 being the strongest year for buyouts and sponsor loans since 2007. They are also holding huge amounts of dry powder, with buyout funds sitting on some $600 billion globally in late 2017, per Preqin. Today, sponsors are leaning much more on senior secured loans to finance their deals than they did in 2005-07, when junior lien and unsecured debt tranches accounted for more of the financing mix. The authors' analysis of 950 broadly syndicated leveraged term loans issued in 2017 and the first quarter of 2018 indicates that 65 percent of these loans were made to private equity-owned companies, while less than 15 percent had any financial maintenance covenants.

## Why Does It Matter?

Thirty years of credit market history emphatically tells us that access to capital and debt default rates are strongly inversely correlated. When risky borrowers have easy access to financing, it nearly always occurs amid a low default environment (as shown in the exhibit), while defaults tend to spike when capital markets are restrictive. This is intuitively understood.

Access to capital can be represented by any of three variables: high-yield market spreads, leveraged debt issuance or the distressed debt ratio. These variables begin to deteriorate nine to 12 months in advance of an upswing in defaults. Currently, none of these variables show any indication of weakening, as credit investors continue to pile into leveraged loans. The continued availability of affordable capital has helped many distressed companies stave off bankruptcy and has been a contributing factor to the general downward trend in chapter 11 filings since the end of the Great Recession.



## What Has Changed in 2018?

In a word, plenty. As if leveraged credit markets needed any more stoking, several recent developments have increased the likelihood that leveraged lending volumes will remain strong in 2018 and beyond, provided that the economy avoids recession and shock events.

### CLOs Are Now Exempt from Risk Retention Rules

Collateralized loan obligations (CLOs) are structured investment vehicles that have become the largest institutional buyer of leveraged loans in recent years. Thomson Reuters LPC recently reported that assets under management by U.S. CLO managers are approaching $520 billion, while new CLO issuance has topped $100 billion annually since 2015. The CLO asset class is well understood by money managers and remains very much in demand.

CLOs were subject to the risk retention rule (also known as the "skin-in-the-game" rule) of the Dodd-Frank Act, which would have required most CLO managers to hold at least 5 percent of their funds. Many smaller-to-mid-sized CLO managers would have been challenged to meet this risk retention requirement, so there was considerable concern that the rule ultimately would depress demand for leveraged loans. The Loan Syndications and Trading Association (LSTA), a trade group representing lenders and CLOs, sued regulators in 2014 to exempt CLO managers who did not originate loans from the risk retention requirement and prevailed in February when a U.S. appeals court overruled a 2016 decision that sided against the exemption for CLOs. This latest ruling, which was not appealed, finally settled the issue by exempting most CLO managers from having to own a portion of their funds.

It is widely believed that this exemption will encourage more issuance for a CLO vehicle that already dominates the leveraged loan market. Market-watchers expect that CLO issuance could approach $140 billion in 2018 — easily a record high — while resets and refinancings will extend the investment lives of older vintage CLOs. Credit rating agencies have already cautioned about looser documentation and loan-selection standards of recent CLOs. Such criticism is met with the same reflexive response from CLO managers: Look how well the asset class has performed for over a decade, which is true — until it isn't.

### LLGs Are Likely to Be Revised, Rescinded or Ignored

Leveraged lending guidelines (LLGs) were implemented by federal bank regulators in 2013 in response to concerns about creeping leverage ratios and looser underwriting standards of many syndicated loans, mostly involving private equity-sponsored companies. LLG laid out some broad metrics and other attributes that regulators could consider in determining whether a loan represented excessive leverage or had adequate repayment capacity. There was always some ambiguity as to whether these guidelines were intended to provide broad guidance or were to be strictly interpreted and adhered to by banks subject to regulatory reviews.

Compliance with LLGs varied among banks, but overall leverage levels of syndicated loans began to moderate within a couple of years of LLGs' introduction. Banks did not take kindly to LLGs, as some highly leveraged deals began to bypass the banking system entirely and were financed by large institutional or private lenders not subject to LLGs or federal bank regulations. Large banks that were losing business to private lenders took those complaints to a new administration intent on reducing the regulatory burden on business.

Their pleas were heard. Joseph Otting, President Trump's nominee for Comptroller of the Currency (the primary overseer of federal banks), has made several public comments since his November 2017 confirmation, signaling his intentions for LLGs, indicating that bankers should not feel bound by them. In this ninth year of economic expansion, with interest rates now on the rise, Otting said that he expects that leverage levels on new loans will trend higher in 2018. Fed Chair Jerome Powell is also on record saying that LLGs are nonbinding guidance.

You can see where this is going. Thomson Reuters LPC has already reported several buyout deals done in 2018 or in the market now with leverage levels at 7.0x EBITDA or higher that got financing considerably above the proscribed leverage limits contained in LLGs. This latest plot twist has the makings of a rush for deals that often compromises lenders' business judgment.

### BDCs Can Now Potentially Double Leverage Levels

Business development companies (BDCs) are closed-end investment companies that have become a primary source of loan financing for middle market companies. BDCs can be privately owned or publicly traded companies, and they currently control assets of nearly $100 billion compared to $40 billion in 2012, according to Thomson Reuters LPC.

The $1.3 trillion omnibus spending bill signed by President Trump in March contained a provision called the Small Business Credit Availability Act, which will allow many BDCs to increase their risk profiles by raising permitted leverage to 2:1 debt-to-equity from 1:1 previously, a change for which the industry had been advocating for several years. BDCs are usually characterized as lenders of growth capital to small and middle market companies, but they often finance leveraged buyouts of mid-sized businesses.

The BDC vehicle has shown spotty returns in recent years as it contends with tighter loan spreads and increasing competition from middle market CLOs, private credit funds and other direct-lending platforms. It is hoped that this increase in permitted leverage will help boost returns or give BDCs exposure to less risky loan tranches without lowering total returns. BDCs will remain conservatively capitalized compared to other lending vehicles, but given the fierce competition among middle market lenders, this change will likely encourage more risky lending to speculative-grade borrowers. Middle market companies have never had so many financing options.

## Where Is This Going?

However rational the criticism of apparent excesses in leveraged credit markets might be, let's acknowledge that the skeptics and naysayers about the sustainability of these exuberant market conditions have been off the mark so far. Speculation about the next default wave has been slowly

building since the end of QE in 2014 and has proven to be premature at best, or just flat-out wrong. Nothing of the sort will materialize until credit markets first cool off, then retrench. Even then, history tells us there will be a notable time lag until bankruptcies and defaults meaningfully accelerate. Given the recent developments that will likely encourage more risky lending and forestall debt defaults, and the overall resilience of corporate credit markets, we cannot see that happening before 2020 as things now stand. However, there is an unmistakable sense of top-of-the-market euphoria in the air with respect to aggressive risk-taking by capital providers that is reminiscent of 2007. That is not to suggest that a 2008-like crisis is lurking with respect to timing, rapidity or global repercussions.

Given the high leverage and business vulnerability of so many speculative-grade companies today, it would only take a mild business downturn or run-of-the-mill recession to unleash the next big wave of corporate defaults. It will happen eventually, as it is already baked into the cake, but it could take longer to get going than many restructuring professionals now anticipate. **abi**

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