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Turnaround Topics

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And the Survey Says...

Words of Caution, but Business as Usual, for Leveraged Lenders

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In *Hamlet*, Polonius famously advises his son, "Neither a borrower nor a lender be." Clearly, Polonius was not sitting on billions of dollars of undeployed capital. One decade after the worst financial crisis since the Great Depression caused global financial markets to convulse and very nearly break down, lending institutions, loan funds and other institutional investors today confront an entirely different challenge: what to do with an abundance of capital.

This is no happy accident; central banks in the U.S., European Union and Japan implemented extreme monetary policy measures that flooded global financial markets with liquidity and drove down real interest rates to zero (or less) until the wheels of lending and commerce began to turn again. Today, economists and policymakers debate vigorously over the fragility of the global financial system and the long-term implications of highly accommodative monetary policy. One thing is certain: Credit markets remain inundated with low-cost capital looking for gainful returns.

Nearly a year ago, the authors wrote[2] about the expansion of corporate credit markets and the migration of lending away from traditional banks and toward private capital funds and other investment vehicles. Little has changed since then, with still-buoyant credit markets providing lifelines to many marginally creditworthy borrowers and financing many aggressively structured deals. It seemed as if that dynamic might have changed in late 2018, when credit markets sputtered, but that episode now looks to have been a passing storm — one that reminds us how suddenly the sentiment in leveraged-credit markets can deteriorate ... and snap back.

Today, traditional lenders and various nonbank lending vehicles find themselves competing directly against each other to put money to work as torrents of investment capital are directed to the loan-asset class. This competition has surely benefited riskier corporate borrowers and their ultimate owners. Arguably, it also has resulted in an erosion of loan underwriting standards and practices that is receiving considerable media attention but has had little consequence to date.

Ultimately, lenders must lend, but the terms under which they now are doing so might negatively impact loan performance and recoveries during the next downturn, whenever that occurs. The current market dynamic is a more complicated story than one of lender complacency. As private-equity-sponsored companies dominate middle-market activity, relationship considerations also are impacting loan decisions and terms made by lenders, especially in private credit, where lenders evaluate the totality of their business relationships with sponsors. Such a strategy has its own risks and complicates the lending decision beyond just the merits of the transaction. Further complicating the picture, many of the largest private-equity sponsors now have their own credit platforms, lending directly to spec-grade borrowers, who can bypass bank lenders altogether.

Loan Market Survey Summary

Such ambivalence by lenders is reflected in their responses to FTI's recent Loan Market Survey, which fielded opinions from 104 lenders in two primary groups of respondents in early April 2019 (70 were traditional bank lenders (TBL) and 34 were nonbank lenders (NBL), with 30 percent of all respondents leading their institution's workout group). The survey included a variety of topical questions pertaining to the current and expected lending environment.

1 The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, affiliates or other professionals.
2 Mark Laber and John Yozzo, "Default Surge on Hold as Leveraged Credit Markets Refuse to Buckle," XXXVII *ABI Journal* 7, 14-15, 54-55, July 2018, *available at* abi.org/abi-journal.

A large majority of respondents believe that loan market performance will weaken in the year ahead, yet still expect that demand for loans as an asset class will remain strong — incongruous responses that speak to the vast availability of deployable capital. Here are some of the more notable responses.

Loans in Workout

First, the survey respondents indicated a strong expectation that problem loans soon will be on the upswing. For example, 78 percent of all respondents expect that the number of loans monitored by their workout groups will be increasing over the next year. This sentiment was shared by both groups, with 81 percent of TBL respondents and 71 percent of NBL respondents expecting an increase.

Next, 70 percent of all respondents expect that the number of loans actively managed by their workout groups will be increasing over the next year. This sentiment also was shared by both groups, with 73 percent of TBL respondents and 65 percent of NBL respondents expecting an increase (see Exhibit 1).

Furthermore, 38 percent of all respondents expect that the number of dedicated workout professionals at their institutions will increase over the next year. This is compared to 59 percent expecting no change and only 3 percent expecting a decrease.

With respect to leveraged loans already in workout, a solid majority (56 percent) of all respondents indicated that liquidity constraints were the primary reason that a credit went into workout, followed distantly by maturity/refinancing risk or covenant breaches. In short, most of these troubled borrowers came to the table when they ran out of money, access to credit or a sponsor's financial support. Here, professionals might be seeing some of the impact of covenant-lite loans and the increasing absence of "early warning systems" that provide a mechanism for lender intervention prior to insolvency, as well as relationship considerations in lending.

As to causes of troubled credits, exactly one-half of all respondents believe that loans now in workout were attributable to company-specific or idiosyncratic factors, with the balance triggered by external factors such as industry-related trends or macro-driven events. However, these responses differed between the two primary groups, with just 44 percent of TBL respondents saying credits in workout were caused by company-specific factors, versus 62 percent for NBL respondents. Such a gap suggests differing views on the prevalence of broader external or systemic risk factors as contributing causes to financial distress among troubled credits.

Workout Resolution

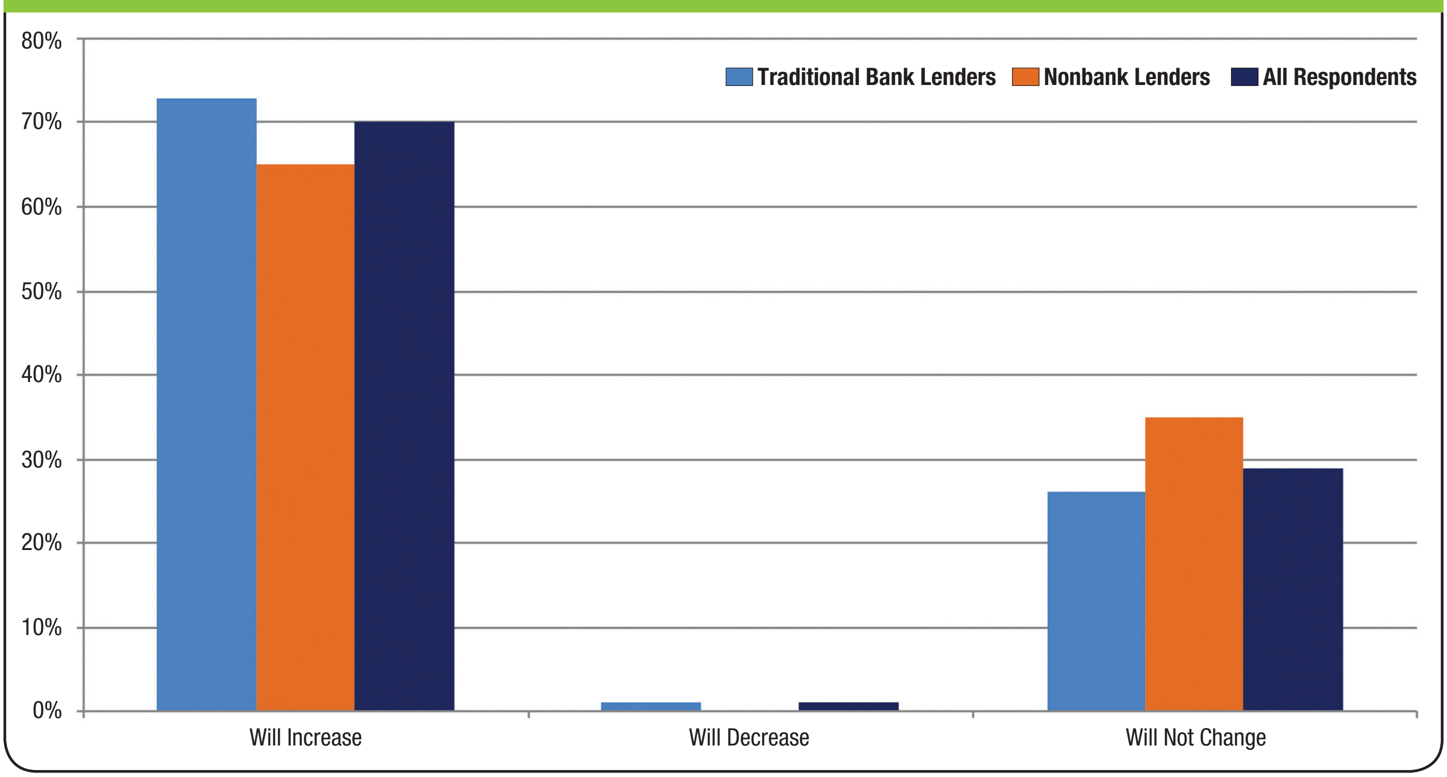
Overall, two-thirds of all respondents primarily resolved loans in workout via refinancing (34 percent) or a renegotiation of credit-agreement terms (33 percent). Outcomes involving a transaction or event, such as deleveraging of junior debt, a sale of the business, loan sale/disposition or a credit bid/foreclosure event, collectively accounted for one-third of all workout outcomes.

However, NBL respondents were much more likely than TBL respondents to resolve a workout via a transaction or event rather than a refinancing or renegotiation of a credit agreement, with 50 percent of NBL respondents reaching workout resolution via a transaction or event compared to 25 percent for TBL respondents.

Distress by Industry

Industry sectors most vulnerable to financial distress over the next year were the usual suspects, according to

Exhibit 1: In the Next 12 Months, the Number of Credits that Your Workout Group Is Actively Managing:



respondents, with retail/restaurants, energy and health care ranking first to third in top responses. The expectation of ongoing distress in the energy sector, despite a 35 percent rebound in West Texas Intermediate oil prices since December 2018, is somewhat surprising but supported by a flurry of energy-related workouts and chapter 11 filings so far in 2019.

The automotive sector placed fourth, as a post-peak auto cycle, ongoing disruption from ride-sharing services and electric vehicles are leaving the sector increasingly vulnerable despite relatively few defaults in recent months. These responses were largely similar between the survey's two primary lender groups.

Demand for Leveraged Loans

Despite expectations of more loans going into workout during the next year, respondents expect that the demand for leveraged loans as an asset class will stay strong for the foreseeable future, suggesting that leveraged-loan volumes will remain robust even with mounting evidence of slowing economic growth and corporate earnings.

Forty-four percent of all respondents expect that the demand for leveraged loans as an asset class will remain strong through 2019, with another 22 percent saying that demand will remain strong through 2020 (see Exhibit 2). Barely one-third (34 percent) of all respondents believe that leveraged-loan demand has peaked or is peaking. However, there was a notable difference in responses between our two groups: 35 percent of NBL respondents expect that leveraged loan demand will remain strong through 2020, compared to just 16 percent for TBL. This likely reflects continuing strong fundraising enjoyed by collateralized loan obligations (CLOs) and private-credit funds, as yield-hungry investors still see attractive risk-adjusted returns in leveraged loans.

CLOs now hold approximately one-half of U.S. institutional leveraged loan tranches, and the economics of the CLO vehicle remain attractive for fund managers and investors alike, making it seem unlikely that this source of leveraged-loan demand will dry up soon. Add to that another record year in fundraising for private credit funds in 2018 and a strong start for business-development companies in 2019, and it is evident that corporate credit risk in this cycle is much more broadly distributed than it was prior to the 2008 financial crisis. For traditional banks, this means competing with unregulated or less regulated lenders who are willing to be very aggressive to get deals done.

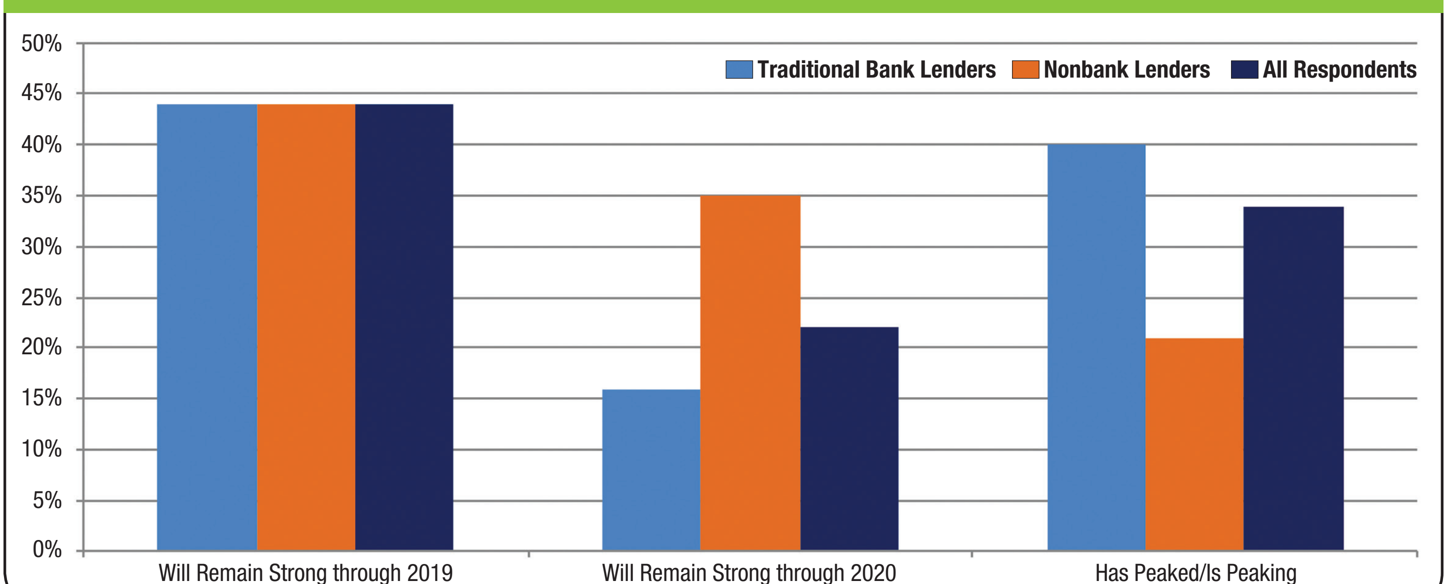
Covenant-Lite Loans

The covenant-lite phenomenon in leveraged lending is no longer a phenomenon. It has become the norm, with more than 80 percent of institutional loans considered "covenant-lite" since 2017. Private-equity-owned borrowers continue to opportunistically steer the market toward covenant-lite. Lenders' rationale for conceding on loan covenants is that financial covenants are a superfluous protection for a well-secured loan that most borrowers will pay a price bump to get rid of. Lenders today are also motivated by FOMO (or the fear of missing out) on deals that will bypass them if they do not acquiesce to borrower-friendly terms.

Another supporting argument for covenant-lite loans is that should collateral value dissipate because financial covenants are lacking, those losses will fall first and foremost on junior creditors, presumably leaving senior secured lenders mostly or entirely unimpaired. However, the survey responses do not necessarily support that premise.

Seventy-five percent of all respondents believe that recovery rates on covenant-lite leveraged loans will be lower than leveraged loans with financial covenants. This response was nearly identical between the two primary lender groups. While the economic-value potential of an equitized senior loan is often highly prized by distressed investors, traditional lenders who find themselves as the fulcrum securityholders by the time they come to the table might be unwilling or unable to be equitized, and would likely be more amenable to accept a fair or reasonable exit price for their loan exposure rather than hold an ownership stake in a reorganized company.

Exhibit 2: Demand for Leveraged Loans as an Asset Class:



Leveraged Loan Rates

Three-quarters of all respondents expect leveraged loan spreads to increase over the next year, with another 12 percent expecting spreads to increase significantly by more than 100 basis points. Leveraged loan spreads already have widened to date in 2019, which makes the economics of the loan asset class more attractive to investors, provided that loan default rates remain very low.

Summary

It is a unique time in leveraged-credit markets and one without any obvious precedent. The authors cannot recall another period when traditional bank lenders had so much business competition coming from nonbank lenders.

The survey discussed in this article indicates that many leveraged lenders are wary of an economic cycle that is starting to get tired and a complacent attitude among many market participants. Yet lenders still are reluctant to trim the sails. This market will have to cool off considerably before the authors can reasonably anticipate the start of the next default cycle. There is still little sign of that yet. abi

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