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FEATURE

BROKEN LEVERAGED LOANS:
THE COMING FEAST FOR ASSET-BASED LENDERS

BY **HUGH LARRATT-SMITH**

Institutional investors, under pressure to deploy funds, have resorted to taking on even more risk. Hugh Larratt-Smith examines the proliferation of covenant-lite loans in the market and their implications for the industry.

Samuel Du Pont spent his childhood at his father's home, Louviers, across the Brandywine Creek from his uncle's estate and gunpowder factory, Eleutherian Mills. In 1811, when he was nine, he was enrolled at Mount Airy Academy. Because of a failing wool mill, his father was unable to fund his education, so at 12 years old, Dupont enlisted in the U.S. Navy. His family's close connections with Thomas Jefferson helped him join as a midshipman.

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Since no naval academy existed at the time, Du Pont learned mathematics and navigation at sea and became an accomplished navigator by the time he joined the USS Constitution in 1821. By 1862, he was appointed Rear Admiral for his brilliant tactical success in securing the southern waters of Georgia and the entire eastern coast of Florida. He established an effective blockade to stop confederate cotton exports to England.

The war was not going well for the Union in late 1862 and early 1863. Although the Confederate Army of Northern Virginia was repulsed at Antietam, it escaped intact and had inflicted a major defeat on the Federal Army of the Potomac at Fredricksburg, VA. In the west, the campaign for control of the Mississippi River was bogged down at Vicksburg, MS. In Texas, the confederates had retaken Galveston. A mood of war weariness was evident throughout the north, and the fall elections — regarded as a referendum on the war — showed a swing away from the Republican Party. The Lincoln administration applied great pressure on its field commanders to achieve success and lift the national spirit. The Navy began to urge an attack on Charleston.

By late 1862, Charleston was of limited military significance, as the active centers of combat were mostly in Virginia and the interior of the country. The Union selected the city as a target more for its symbolic worth than its strategic importance. As one participant in the naval attack said, "Fort Sumter was regarded in the public mind, north and south, as 'the incarnation of the rebellion.'"

Towards the end of 1862, Du Pont was the first U.S. naval officer assigned to command the newest technology — armored, "ironclad" ships. Though he commanded

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these new ships ably in engagements, the ironclads performed poorly in an attack on Fort McAllister due to their small number of guns and slow rate of fire. Du Pont did not share the enthusiasm of the Navy for the armored vessels. Although they could withstand the punishment of the coastal artillery, their offensive capabilities were severely restricted.

Du Pont received direct orders to launch an attack on Charleston, the main area in which the Union blockade had been unsuccessful. Though Du Pont believed that Charleston could not be taken without significant land troop support, he attacked with nine ironclads on April 7, 1863. Unable to navigate properly in the obstructed channels leading to the harbor, his ships were caught in blistering crossfire. Five of his nine ironclads were disabled in the failed attack, and one more sank. The attack was poorly planned by the Navy. The Army refused to provide adequate land support.

The Navy blamed Du Pont for the highly publicized failure at Charleston. Du Pont attempted to garner the support of President Lincoln who ignored him. He returned to Delaware in disgrace in 1863. As an officer, he could not publicly blame the Navy for its poor planning and underestimation of risks or the Lincoln administration for its pressure for newsworthy success.

Fast forward to 2020.

INVESTORS UNDER PRESSURE

Institutional investors are under pressure to deploy funds. Ten-year U.S. government bonds yield less than 2%, while the equivalent German yields are negative. Around $15 trillion of bonds have negative yields, according to the IMF. Investors have resorted to taking on even more risk.

Many observers of the leveraged loan market think the proliferation of covenant-lite loans is a significant underestimation of risk. To say nothing of poor planning at the late stages of the bull credit cycle. Credit risk was mostly a nonfactor for banking investors in 2019, which was all about interest rates. The new year may be different. Indeed, some industry observers think leveraged loans and the auto finance market may trigger the next recession as the bull economic cycle ends.

Banks are the biggest holders of leveraged loans, with more than 40% of the market on their balance sheets, according to Financial Stability Board data. In some ways, that's a good thing. Banks were at the epicenter of the last financial crisis, and they've been fortified with capital to help withstand defaults. They undergo intense testing by regulators to make sure they are sound — the regulators have a good idea about what's going on inside banks and how much risk they're taking. But there's not a lot of data on who is investing in CLOs. We do know banks have considerable exposure to CLOs, either through direct investment or through synthetics like derivatives. CLO vehicles hold about $744 billion of leveraged loans.

Prior to 1999, covenant-lite leveraged loans were far from the norm as banks only offered these structures to the strongest borrowers. However, with the dramatic expansion of players moving into the direct lending space in recent years and the search for yield by institutional investors, flexibility on documentation has become a routine point of differentiation among lenders trying to put money to work. In many cases, investors and lenders like the credit story, so they are willing to tolerate "swiss cheese" loan agreements. They are willing to accept the thesis that pro-forma EBITDA — brimming with add-backs — is achievable.

Industry observers estimate that cov-lite loans constitute 80% of outstanding leveraged loans versus 15% a decade ago. We saw a sports equipment manufacturer with $1 billion in sales running on daily availability of less than $1 million, yet the lenders could not take action. There was no canary in the coal mine. How about cov-lite deals like J. Crew and Neiman Marcus, who moved intellectual property and stores to unrestricted subsidiaries, effectively stripping collateral from their senior secured lenders and hurting the recovery value of their loans?

According to UBS data, average total debt on new deals is about 5.4x EBITDA, but 6.7x EBITDA once the add-backs are stripped out. About 30% of outstanding leveraged deals done since 2017 have add-backs worth about 25% of EBITDA. If EBITDA softens (as it sometimes does, regrettably), leverage can spike quickly… or if the sponsor has done a dividend recap days after the original loan was signed, hitting their coveted IRR of 100%.

S&P recently reviewed U.S. leveraged loans from 2015 to 2016 to see if companies, their sponsors and investment bankers had met the projected EBITDA add-backs — and if leverage levels had decreased according to plan. The findings were resoundingly negative. With new borrowers in 2016, more than 90% failed to hit EBITDA targets by the end of the second anniversary of the loan signing. Leverage at the median company was projected to fall to 3.1x EBITDA by year two, based on financial projections in the Confidential Information Memorandum. No surprise, leverage ended up at 5.9x, according to S&P.

The market for cov-lite loans has suffered sharp declines in recent months, a sign of growing aversion to EBITDA shortfalls or other strains at highly leveraged companies.

In the U.S. at the start of December 2019, some 2.5% of leveraged loans were trading at less than 70% of face value — the most since September 2016, according to S&P. Analysts and investors blame the loose credit standards that characterized the market in recent years, which has been goosed by strong demand from yield-hungry investors.

But investors are quick to dump cov-lite loans at any sign of trouble which is sparking steep falls in the prices of loans — particularly when they fail to hit EBITDA targets. In some cases, the first default is a payment default (no tire skid marks as the vehicle plunges over the edge of the cliff). In the absence of meaningful covenants, leveraged loans trade down quicker — especially in Europe where loan markets are smaller, less transparent and less liquid than in the U.S. — prices drop very rapidly once they go below 80 cents. The debt of Holland & Barrett, a UK retailer of vitamins and health supplements, went into a free fall plunge to less than 50% of face value early in December 2019 after a ratings downgrade from Moody's.

In the U.S., some of the companies whose loans fell below 70 cents on the dollar in recent months include Deluxe Entertainment, a media group whose loans fell to around 40 cents on the dollar in August 2019. Murray Energy and 4L Technologies are two others whose loan values got crushed. Both have restructured out of bankruptcy court. In the past, when debt was too high or earnings didn't improve, covenants could push companies and lenders to renegotiate terms, which would protect the value of the loan and give the company room to fix its problems. Today, a lack of protection is both encouraging some investors to sell sooner and is reducing the price that distressed investors are willing to pay.

CLOs, which have become the dominant investor type in leveraged loans for the past few years, have very strict limits on the amount of CCC loans that they can hold. Many CLOs try to sell loans before downgrades are announced, so they don't become forced sellers.

And there are fewer buyers for these loans because of another borrower-friendly condition that became a popular part of loan documents, particularly in Europe — "Black lists" — or more politely phrased "transfer restrictions." Black lists limit banks from exiting a credit by selling the loan to specific lenders and investors, which is the preferred route at the first sign of trouble. In some cases, banks will end up with leveraged loans that they want to exit but can't on terms that are acceptable because the universe of purchasers has been severely constrained. ABL players may be well positioned to buy entire leveraged loan portfolios that are primed for restructuring.

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While cov-lite loans have become increasingly prevalent in the broadly syndicated lending market, this pattern has not yet been reflected across the middle-market ABL environment. The ABL world has seen some impact in the hunt for outstandings and yield. We are all hearing more and more about enterprise value. Some ABL shops have taken a dramatic shift in underwriting to include enterprise value. Some players call it a stretch piece of the deal. Like many industries, ABL has become intensely competitive with significant margin compression. To stay in the game, many ABL players have to partner with leveraged lenders — or finance a sponsor-driven deal on a highly desirable borrower with swiss cheese documents that are more like equity than debt.

TROUBLE AHEAD?

Nagging questions for many credit committees are: How will the sponsor behave in a workout?

Will the sponsor become belligerent in a fight? Will the sponsor quickly throw the keys on the table? Will the sponsor recapitalize the company? (Not after the last dividend recap gets put to bed). Who will control the fulcrum security on the capital stack?

With troubled stretch loans underwritten with some estimate of enterprise value (a wet finger in the air), lenders may opt for a quick distressed sale rather than a liquidation, even if the risk of recovery is less than 100%. With the multitude of distressed investors on the prowl for opportunities, going concern sales are much more prevalent today than 10 years ago. In many cases (other than retail), a quick going-concern sale is the preferred path, especially if a large availability block to "foam the runway" exists.

For many borrowers burdened with excessive debt and declining margins weakening the debt capacity of the borrower, out-of-court restructuring may be a better option than Chapter 11. Given the high leverage in some situations, a bankruptcy judge may rule the company to be administratively insolvent, so the stakeholders may prefer to negotiate in conference rooms instead of bankruptcy court.

Despite the proliferation of new ABL players, the ABL marketplace will benefit from an increase in loan demand as leveraged loans are replaced with conforming ABL structures in the next downturn. With banks holding 40% of leveraged loans, cashflow lenders within those banks will turn to their ABL teams to augment the capital stack of borrowers.

PREPARING FOR THE DOWNTURN

The questions on many lenders' minds are: When will the next downturn start? How long is this bull economic and credit cycle going to last?

Many economists think that manufacturing, freight, retail and agriculture are already in recessionary mode. Despite the ever-increasing share of GDP that the service sector has, manufacturing still drives 10% of the U.S. economy. While only 8.4% of all jobs are in manufacturing — continuing a long downward trend since World War II — many of these jobs are well-paying, which feed the consumer spending part of the economy. In 2019, U.S. payrolls kept expanding, but paychecks in the service sector stalled. And AI is relentlessly replacing workers in all sectors of the economy.

Truck freight rates have slumped. Rail rates have halved in the past year. The Baltic Dry Index, a bellweather of the global shipping market, has hit an all-time low as the spread of the coronavirus weighs on global trade.

The fast-spreading virus and uncertainty around its impact on the world's economy have rocked markets and sent commodities prices to multi-month lows. That has added pressure to shipping freight rates for the world's largest raw materials ships, known as cape-size vessels. The Baltic Exchange's cape-size index, which constitutes part of the Baltic Dry Index — an important proxy for the world's shipping market — extended deeper into negative territory in February, after slipping below zero for the first time ever in late January. The recreational vehicle sector — another bellweather of consumer spending — has weakened dramatically over the last six months.

When China coughs, supply chains fall ill. The impact of the new coronavirus on factories in China could affect the global supply chain for years. The robustness of global supply chains is being tested. Even products with a small quantity of Chinese content will be affected as production is halted in the affected areas in China — items such as complex machine and vehicle parts, hard drives and certain electrical items that are vulnerable to supply shocks. For example, General Motors closed U.S. and European plants after the Japanese earthquake in 2011 and 2016 because critical parts could not be readily sourced elsewhere. Already, some Ohio manufacturers are substituting local suppliers in place of Chinese suppliers to ensure continuity of supply.

Data collected on weekly container vessel calls at key Chinese ports already shows a reduction of over 20% since early January. Brokers in China said bookings for container ships, tankers and dry bulk vessels are falling rapidly and that the slowdown could extend until March. The reduction in shipping volumes is expected to ripple across supply chains in the U.S. and Europe, with rail and truck volumes likely sliding further in the coming weeks on the reduced flow of international goods. In 2003, China accounted for only 4.3% of global output, far below the 16.9% projected for 2020.

For middle-market borrowers, drastic change in supply chains can force sudden swings in profitability. Take the dance and cheerleading clothing industry — think everything from ballet tutus to tween cheer clothing. Many of the major players in this industry are currently in a crisis because their Chinese shipments have been canceled just as the dance performance season is coming to its climax in March. When their dance and cheer costumes arrive in Long Beach — if they arrive — customers will have already cancelled their orders.

A chorus of bellweather Fortune 500 manufacturers — 3M, Caterpillar, Dupont, Honeywell, Black&Decker, and PPG — expect the sluggish conditions of 2019 to extend into 2020, particularly in automotive and oil-and-gas drilling. U.S. chief executives are getting worried about a recession. Fear of an economic decline topped the list of their concerns going into 2020, according to a survey from the Conference Board. In the year prior, recession fears ranked third for U.S. chiefs — though at the top of the list for CEOs around the world — as is again the case for 2020. Going into 2018, the topic of recession was barely a blip in the survey data. With the global economy growing only at a rate of 3% in 2019, this worsening corporate sentiment could lead to a slowdown in 2020 growth to 2.5% — the level the IMF considers a global recession. One quick datapoint: The American Bankruptcy Institute reported that Chapter 11 filings in January 2020 increased 72% over the same period last year.

Leveraged lenders and sponsors should be ready to see what the party really looks like when the lights are turned on. The party will just be starting for ABL players who will be feasting on broken cashflow deals.

In 1882, 17 years after Du Pont's death, Congress finally moved to recognize his service and commissioned a sculpture of him to be placed in Washington, D.C. Events subsequent to the Charleston ironclad fiasco vindicated Du Pont's judgment and capabilities. A second U.S. naval attack on the city failed, despite being launched with a significantly larger fleet of armored ships. Charleston was finally captured only by the invasion of Sherman's army in 1865.

A bronze sculpture of Du Pont was dedicated on December 20, 1884 with President Chester A. Arthur in attendance, and the traffic circle was renamed Dupont Circle. •

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