Credit: Good News and Bad News

June 28, 2018 - Deal trends might be reversing (slightly). It is still true that, with default rates low, LBO leverage remains high, maintenance covenants are rare and debt cushions are thin. But on strong second quarter supply, power has shifted slightly in favor of lenders – and this has driven a modest tightening of deal terms. We review such trends below.

As a backdrop, default rates are low – and are expected to remain there: Fitch sees the leveraged loan default rate at 2.5% in June, matching its year-end forecast. Of course, low default rates generally are joined by loose deal terms. And, indeed, leverage remains high. LevFinInsights has tracked 15 deals levered 7x or higher during second quarter; this is up from seven in the first quarter and 21 for all of 2017. In addition, S&P/LCD reported that covenants and debt cushions are lighter than they used to be: 77% of outstanding loans in the S&P/LSTA Leveraged Loan Index (LLLI) are covenant lite. Meanwhile, debt cushions on covenant lite loans average 22% in 2018 year-to-date, down from 35% before the financial crisis. Covenant heavy loans enjoy an average 17% debt cushion today, vs 28% in 2007. Moreover, 23% of cov-lite loans and 42% of cov-heavy loans have no sub debt at all.

But there's good news as well. For one, investor spines have stiffened recently and flex activity has begun to favor lenders. Both LevFinInsights and Thomson Reuters LPC report that June has seen more upward price flexes than downward ones. But covenants also have flexed in investors' favor, LFI added. Xtract detailed changes they have seen in four recent loan documents: i) MFN language has been expanded, ii) soft-call periods have been lengthened, iii) EBITDA adjustments have been capped and the look-forward period has been reduced, iv) asset sale proceeds language was tightened, v) ratios for unlimited RPs were shifted tighter to meet market expectations and vi) reporting holes were eliminated.

What drove this flurry of spine stiffening? Primarily technicals. Outstandings in the S&P/LSTA Leveraged Loan Index have hit $1.044 trillion, up $55 billion in the second quarter and $89 billion in the year-to-date. This substantially eclipses 2018 visible demand, highlighted by $56 billion of CLO issuance and $11 billion of loan mutual fund inflows.