THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Credit: Past, Present and Future

August 2, 2018 - Default articles may chronicle the past. After all, today's defaults are dictated by terms and conditions of deals structured years earlier, borrower behavior in the ensuing years – and often already are priced into the market. With that caveat, we nonetheless i) celebrate today's low default rate, ii) consider tomorrow's default forecasts, and iii) discuss general structural trends (and U-turns) this year.

While they use different universes and thus post slightly different results, both Fitch and S&P/LCD report benign default news. Fitch noted that July leveraged loan defaults were light – they tracked just one – and saw defaults at 2.3%, down from 2.5% in June. In particular, the retail default rate has fallen to 4%, down from 7% in June and a recent peak of 8.7% in April. All told, Fitch sees the year-end default rate in the 2.5% context.

S&P/LCD, meanwhile, tracked nary a default in July in the S&P/LSTA Leveraged Loan Index (LLLI). In turn, the trailing 12-month default rate was a slim 1.97% by volume (and a slimmer 1.59% by issuer count). To be fair, this is up from recent lows of 1.36% in July 2017, but it remains well inside the 3.1% historical average. So where do default rates go? Based on the highly rigorous investor tummy test model, LCD sees a 2.46% default rate in 12 months and 2.65% at year-end 2019. Why so benign? The usual suspects. First, interest coverage ratios are very strong. Just 3% of LLLI constituents have an interest coverage ratio below 1.5x, a level that suggests a company is struggling to service debt. (For comparison, in the crisis, 18% of companies fell below this threshold.) Moreover, borrowers have been using benign conditions and favorable technicals to repeatedly push out their debt maturities. Thus, triggers for a broad rise in defaults are limited.

So, good news today and tomorrow. But longer run, lenders suggest that looser deal terms may foster higher (if later) default rates and lower recoveries. As we noted last week, looser loan terms certainly have been a consistent theme this year. But as we also added, pushback on loose document terms began in second quarter and accelerated in July. This week, Xtract extended – and provided nuance for – the narrative through their 2Q18 review of loan terms and conditions.

Before diving into results, let's define the universe. Xtract divides its dataset into three cohorts. First are Large Sponsored Deals with TLBs over $350 million; they tracked 229 in the last 12 months and 69 in second quarter. Next are Middle Market Sponsored Deals (TLBs under $350 million), of which there were 105 in the last 12 months and 28 in second quarter. And finally, Non-Sponsored Corporate deals with TLBs over $350 million, of which there were 105 in the last 12 months and 33 in second quarter.

Unsurprisingly, Large Sponsored Deals tend to be the bellwether credits, Middle Market Sponsors often pick up the trend next and Corporates lag behind. So what do the data show? Bellwether Large Sponsored Deals saw lender-friendly improvements in a number of areas and Middle Market Sponsored Deals remained relatively steady. But Corporates played catch up – which means they loosened terms – and this drove aggregate terms looser.

What specifically changed? On the Large Sponsored side, Xtract noted tightening on EBITDA addbacks, in particular the share of loans allowing uncapped savings addbacks fell to 59% from 68% in first quarter. Likewise, Most Favored Nations language favored borrowers less. Deals with MFNs with less than 50 bps protection dropped to 25% from 43% in first quarter; deals with sunsets dropped from 83% to 46%. Finally, the share of Large Sponsored Deals with "trap doors", which allow non-guarantor restricted subsidiaries to invest in unrestricted subsidiaries with the proceeds of any investment in them, fell to 7%

from 11% in first quarter.

Middle Market Sponsored Deals mostly stayed the course, though lenders lost ground in uncapped cost savings EBITDA add-backs (59% in second quarter vs. 46% in first quarter) and MFN sunset provisions (67% vs. 44%).

But Non-Sponsored Corporates, which are more conservative and generally lag the sponsored market, trended looser. Uncapped EBITDA addbacks increased from 21% to 27%; MFN sunsets increased from 38% to 50%; and covenant lite loans – a battle long since lost in the Large Sponsored space – increased from 57% to 73%.

In the long run, lenders generally still see senior secured loans as an attractive – and relatively safe – investment. But structural changes in documents may chip away at that historical 70-80% recovery rate.