The Leveraged Loan Market
2017 Review and 2018 Preview

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On Deck for Today…

- The 2017 technical picture
- What it meant for T&Cs
- Where 2018 may go
- Public sector plans, private sector impacts?
Nominal Lending Volumes Strong… But Mostly Refinancing and Repricing

Institutional and Pro Rata Gross Lending Volumes

2017 Institutional Lending Activity: Dominated by Repricings

Source: Thomson Reuters LPC, S&P/LCD
There Was Decent M&A…
But Even This Created Modest Net Lending

- Net Loan Supply According to LevFinInsights was $160B
- Net Growth in the S&P/LSTA Loan Index was only $72B

Source: Thomson Reuters LPC, LevFinInsights
Visible Institutional Demand Greatly Outstripped Supply

Since 2012, Cumulative Institutional Demand Has Outstripped Supply by $162B

Source: Thomson Reuters LPC, S&P/LSTA Leveraged Loan Index
Impact: Reduced Opportunities in Secondary Market

Bid Appreciation Opportunity in 2016; Prices High and Flat in 2017

By 2017, Many Loans Bid Above Par

Source: Thomson Reuters LPC, SMI
Impact: Declining New Issue (and Portfolio) Spreads

New Issue Loan Spreads vs. Average Outstanding Loan Spreads

- New Issue BB/BB- Spread
- New Issue B+/B Spread
- LLLI Nominal Spread

Source: S&P/LCD, S&P/LSTA Leveraged Loan Index
M&A Docs Looser: Adjustments Increasing, Accordions Growing

EBITDA Adjustments on M&A Deals Increase

Free & Clear Accordion Sizes Trend Up

Source: Covenant Review
M&A Deals: Tracking Movement From Basic Leverage to “All-In” Leverage

Leverage Trends Based on ADJUSTED EBITDA

Leverage Trends Based on REPORTED EBITDA

*Note, 4Q17 moderation in leverage due to increase in corporate cohort

Source: Covenant Review
Where Do We Go in 2018? Default Rates Flat

Institutional Leveraged Loan Default Rate

Source: Fitch
Where Do We Go in 2018? Pro Rata Lending Up, Institutional Flat to Down

Pro Rata Lending Expected to Climb

Institutional Refis Down by 40%, New Lending Expected Flat

Source: Thomson Reuters LPC
So Where Do We Go in 2018? Institutional Spreads Flat to Down

BB Institutional Loan Spreads Flat(ish), B Spreads Down(ish)

Source: Thomson Reuters LPC
So Where Do We Go in 2018? Returns Looking at “Sub-Coupon” Year

Forecast Components of Institutional Loan Return in 2018

- **Nov-17 Levels**
  - Coupon: 351
  - Libor: 150
  - Libor Change: 40
  - Default Loss: (50)
  - Repricing: 25
  - Price Chg: 18
  - Total Return: 450

Source: Barclays
Regulatory Watch List

- LIBOR
- Leveraged Lending Guidance
- Tax Reform
- Risk Retention
- Flood Insurance
- Custody
- Volcker Rule
Why LIBOR Might “Go Away”

• Allegations of manipulation by LIBOR submitters during the financial crisis

• Submitters in tough spot
  • Decline in liquidity of LIBOR
    • More than 70% of three-month LIBOR submissions are based on “expert judgement” by submitters, not actual transactions or interpolation of transactions
  • Liability for LIBOR submitters

• Speech by Andrew Bailey, Chief Executive of U.K.’s Financial Conduct Authority indicated they were not going to force banks to submit LIBOR after the end of 2021

• It’s not clear whether banks will choose to continue submitting thereafter
Proposed US$ LIBOR Replacement: Introducing SOFR

- **SOFR**
  - Cost of overnight loans that use US government debt as collateral
  - It is liquid and deep, with average daily trading volume of more than $700 billion
  - It will likely remain robust over time

- **Issues for cash markets?**
  - It’s an overnight rate, not a term rate
  - It’s a secured repo rate
  - It’s lower than LIBOR

- **Some milestones**
  - FRBNY will publish SOFR starting mid-2018
  - Term curves should develop once trading begins; term reference rate scheduled by end of 2021
  - “Credit spread” calculated for legacy “contracts”?

![Graph: 3-Mo LIBOR vs 3-Mo Compounded SOFR](Source: FRBNY, St Louis Fed)
LIBOR: What Do Loans and the Loan Market Need?

- Credit spread between LIBOR and SOFR?
- Economic equivalency on date of transfer?
- Term reference rates (1-month, 3-month) vs. overnights?
- Multicurrency facilities?
- Infrastructure/technology?
- Hedging capability?
LIBOR: What Can Market Participants Do?

- Check your existing documentation for fallback language
- Review new loans/amendments for LIBOR transition language
  - Agent/borrower determination?
  - Agent/borrower determination with negative consent?
  - Agent/borrower determination with majority amendment?
- Engage with the LSTA on our LIBOR work streams!
Leveraged Lending Guidance
Leveraged Lending Guidance: The Players and Actions

- In February 2017, President Trump signed order to refine and streamline financial regulation.
- In March 2017, Senator Patrick Toomey (R-PA) sent a letter to GAO alleging that Leveraged Lending Guidance was a rule under the Congressional Review Act, and asking GAO to opine.
- In June 2017, the Treasury said that the Leveraged Lending Guidance should be refined.
- In October 2017, the GAO said Leveraged Lending Guidance was a rule.
- In November 2017, Representative Luetkemeyer (R-MO) sent a letter asking the Fed, OCC, FDIC to respond to the GAO report.
- In November and December 2017, the Fed, OCC and FDIC suggested they would considering reopening the Guidance for comment and refinement.
To move forward on any refinement of Leveraged Lending Guidance, may need all new Agency heads confirmed

- OCC in place
- Jerome Powell confirmed as Fed Chair by Senate on January 23, 2018
- Hearing for FDIC Chair on January 23, 2018

Potential process

- Determine what the market needs: Definition of “Leveraged Loan” vs. “Non-Pass Origination”
- Request for Comment? Notice of Rulemaking?
- Comment Letter
- New/Refined “Rule”?