Dollars and Scents

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News reached us over the weekend of a new trend in baseball. Apparently several Chicago Cubs relievers are applying copious amounts of perfume as a good luck charm. Turns out players from last year's Kansas City Royals did the same thing. And they won the World Series. The Cubs manager tweeted, "Aroma still matters."

A different kind of fragrance is wafting through the leveraged loan market these days. A combination of factors is leading to a more aggressive stance by large cap arrangers. As noted by the WSJ this week, the broadly syndicated market is stretching the definition of cash flow to justify high purchase prices. And therefore more leverage.

The article zeroed in on the use of "liberal earnings adjustments" to bring leverage below six times ebitda. That's the Leveraged Lending Guidance ceiling for banks, above which draws scrutiny, and a potential criticized classification, from regulators.

This column regularly highlights the nuances of ebitda adjustments related to leveraged buyouts – which ones meet the sniff test, and which ones carry a less agreeable odor. For example, adding back costs related to specifically identified headcount reductions has long been a recognized feature of adjustment tradition.

"Pulling forward" earnings (as the WSJ observes) can be more problematic. It's one thing to cite LTM (last-twelve-months) ebitda performance to support a leverage multiple; it's quite another to use a projected year-end 2016 result. "Those cash flows are booked" is arguable when the borrower still has six months of numbers to report.

Chatting with loan managers this week, we sense the middle market has not been immune to some ebitda hijinks. "This is worse than 1999," one long-time practitioner told us at an industry gathering. "At least then total leverage was below five times. Today we're seeing games being played north of six times for pretty small companies."

It is certainly not news that both sponsors and lenders tend to push the envelope on pricing and structure during times of low deal flow. What makes the current froth different than past periods of exuberance is that one-stop providers don't care whether "the market" will agree to stretchy terms. These arrangers avoid the syndication track by tucking away the entire loan in its internal pockets.

All of which underlines the value of experienced managers who understand what quality of earnings means. "I can underwrite aggressive adjustments for a business that has real scale and performed through the downturn," a senior debt principal said, "But some of these shops are run by thirty-somethings who were in school in 2008."

Another middle market pro agreed. "This is not the time to be doing stupid stuff," he said. "If you're chasing yield by pushing leverage, you may wake up with a bunch of loans underwater when the next cycle hits. If you're a firm with a lot of capital and not in a hurry to deploy it, that's a great place to be right now. If you stay within your risk tolerance, and stick with the best credits and sponsors, you'll be around a while ."

In other words, experienced lenders will know a good market when they smell it.