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2017 – A Look Ahead (Third of a Series)

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Last week we punctured the myth that the influx of new private debt funds is creating excess demand for the level of deal supply of middle market senior loans [link]. We now turn our attention to credit quality. How will this year fare for credit investors relative to years past, and expectations?

First, let's separate the creditworthiness of the borrower from the structures imposed upon them. In general, top-line performance of middle market companies should receive support from the economy over the next year or so. While specific tax, trade, and fiscal policies are evolving, domestic tailwinds should be sufficient in the short-run to give some lift to US-centric businesses.

Of course, not all sectors will feel the same breeze at their backs. Heathcare, for example, is likely to be subject to regulatory changes. Retailers will be challenged by some international tariff proposals being discussed. And who knows what the outlook for energy-related issuers will be? But most economists believe there is more upside than downside to 2017 GDP growth, even if it's a modest rise early on.

From a markets perspective, many credit investors have noted since mid-2016 how increasing liquidity, particularly in broadly syndicated loans, is driving pricing and structure. This trend has accelerated over the past few weeks, highlighted by a plethora of repricings and refinancings. Strong borrowers are seeing pricing trimmed by 100 bps or more.

Of greater concern is the releveraging of less-creditworthy companies based on significant ebitda adjustments. As we've highlighted in the past, add-backs to cash flow calculations are not all created equal. Some are of dubious merit. One favorite making the rounds is a boost in ebitda based on management's expectations of new business coming in over the next twelve months. As one banker tweeted: “LOL.”

Faux cash flow forecasts can undermine portfolio quality by masking borrowers' true leverage. If unrealistic ebitda assumptions aren't met, performance can deteriorate without it becoming apparent for several quarters. In the case of covenant-lite loans, even if leverage skyrockets, lenders have fewer triggers to compel changes.

As a recent FT article noted, it's not just covenant quality that suffers dilution from phony add-backs. “The important consequence of having an inflated adjusted ebitda number,” one portfolio manager said, “is that all the provisions key off that number. You are opening up more financial flexibility to lever the company up more.”

Experienced lenders are also mindful of where they are in the capital structure. At the moment, second liens have made a modest comeback, at least for large cap deals. With higher purchase price multiplies, the assumption is there's plenty of cushion below you. That may not be the case in a downside scenario. If structures and terms are too loose, you don't need a recession to impact borrower performance.

Next week we wrap up series with a look at what exogenous factors could impact asset managers.