Déjà View

THE LEAD | January 3, 2018

Another year, another fruitcake article.

This one from last Thursday's WSJ. Long-distance hikers are the latest consumer market niche to fall for the oft-abused holiday fare. "Better than energy bars," one new fan enthused. "We're just burned out on gorp," explained another.

No less a personage than Appalachian trail guru, Edward Garvey, gave the fruit-and-nut treat a thumbs up. We're sure he spoke for us all when he wrote: "This fruitcake is easy to pack, keeps well, and is delicious to eat. What more could one ask?"

As we returned refreshed to civilization after the break, our thoughts returned again to adventures of a less outdoorsy sort; notably, the 2018 outlook for the capital markets.

In a coming piece for the LSTA reviewing the year just past in the middle market, and looking to the year ahead, we address five broad themes – all of which should be quite familiar to *Lead Left* readers.

First is the issue of credit inflation. As more cash flows into the leveraged loan space, and high-yield instruments in general, the more structures weaken and values cheapen. The problem with cov-lite for middle market loan buyers, as we've outlined previously, is that a junk bond feature is being applied to a very un-bond-like security.

Next is the distortion of ebitda definitions. The convergence of loans and bonds impacts credit agreements as well as structures. Variations on this theme are well-known by now. What's insidious is how other terms and covenants in documents have also become stretched, and how that affects the entire CA.

Then there's the march of more senior debt in middle market structures, bringing with it both higher leverage and absence of junior capital cushions. Rating agencies have noted this will likely weigh negatively on loan defaults and recoveries. It's also possible the new limits on interest expense deductibility will further accelerate this swing.

Another 2018 topic is the growing scale of midcap arrangers. Buttressed by unitranche and first out/last out partnerships, we've also seen them expand their sell-side capabilities. The latter comes into play when cov-lite makes some assets less palatable to hold.

That leads us to the last theme: liquidity. Bringing BSL terms to the middle market doesn't automatically bestow on MM loans the same capability to flip out of a position. Large cap holders can sell for whatever portfolio or issuer reason – rating change, price move, earnings surprise, or industry concentration. Not the case for smaller loans.

Of course all bets are off in the face of an exogenous event. And it doesn't need to be a dramatic one. As one observer wisely noted, "We've gotten used to things being very good. We don't need the tailwinds to turn into tailwinds, we just need a couple to go away to find ourselves in a very different market environment."