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Terms They Are A-Changing

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There’s nothing that takes the froth off an issuer-friendly market faster than a growing pipeline. Absent some kind of global galactic event like a meteor strike or Iceland winning the World Cup, it’s good old-fashioned supply that impacts demand.

In part, it’s a matter of band-width. Loan underwriting, even for liquid, on-the-run, broadly syndicated names, is labor-intensive. Asset managers are a lean bunch staffing-wise. Analysts can juggle only so many live deals at once. Add one more to the pile – especially a “story” or if terms are too aggressive – and it will be set aside.

If too many buyers disengage, the arranger’s sales desk will quickly call around, asking, “Where do you care?” Translation: What will it take for you to pick the deal back up? Better pricing? Lower leverage? A covenant? Higher OID? Change what the company does?

If the healthy new deal flow continues, more borderline credits will be sent back to the shop and reworked. Keep it going longer and even the better financings will see some investor-friendly modifications. Give it a month or two and we could see the pendulum swing further to the buy-side.

How does the middle market fit into this dynamic? As we’ve said before, mid-caps don’t repeat exactly what’s going in the broadly syndicated market. But they do rhyme.

The sequence goes like this: As large cap terms change, particularly the most visible ones like pricing and leverage, loan managers rework their relative value calculations. If a liquid, single-B issuer prices up to L+375 bps, from L+325, it’s hard for a middle market borrower to be at the same spread. So arrangers will boost smaller issuers’ spreads up to L+475 (or whatever) to maintain the illiquidity premium.

This reset occurs over time. But occasionally, as was the case in August 2015, the shift can happen overnight. When China and commodity concerns roiled the markets three years ago, volatility spiked. Bankers with deals in the market went scurrying into hasty meetings with clients, digging out flex language from commitment papers.

We are in the very early days of this cycle. If deal flow eases, it could end up being a big nothing burger. At this stage, investor pushback is not always evident. The most obvious terms like pricing and leverage might show only minor tweaks here and there. But deeper in the credit agreement, there are signs of buyer power.

In an upcoming *Lead Left* interview, analysts at *Covenant Review* highlight how things like MFN [most favored nation] sunset periods are being lengthened. How delayed draw periods are being shortened, albeit from still longer than normal tenors.

Of course, the vast majority of leveraged loans being launched still bear the marks of a very aggressive bull market. But if the pipeline continues to build, investors may finally see more terms blowing their way.