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Search and Recovery (First of a series)

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You know we're at some kind of inflection point when two former chairs of the Federal Reserve come out in the same week with warnings about risks in financial markets.

First, in an interview with the Financial Times, Paul Volcker spoke about systemic risks: "There's a lot of leverage going on now, a lot of debt . . . interest rates are very low." He also worries about "chicanery" from players trying to loosen regulation designed to protect against excessive behavior.

As he prepares to launch his new book, *Keeping At It*, Mr. Volcker weighed in for a similar WSJ piece. He said, "These financial markets are going wild…There's so much confusion, risk-taking, leveraging, debt increases – but who's minding the store?"

Minding the store, in an FT profile, was a forthright Janet Yellen. This ex-Fed chair highlighted various trapdoors awaiting investors. Echoing her predecessor, Ms. Yellen said lower quality, higher leveraged issuers could add to systemic risk: "There are a lot of holes. We should not feel the financial stability glass is half full."

Finally, the WSJ published an article on how risk is returning to leveraged buyouts. It was entitled, "Risk Returning to Leveraged Buyouts." Lead Left readers will be intimately familiar with its talking points – higher leverage, weakening terms, and regulated banks staying away from "risky loans."

All this leads us to examine closely (as the title of one panel we spoke on this week put it) where "the rubber meets the road" on private credit. As the adults in the room start getting antsy, it's time to consider two of the most fundamental questions in the asset class. First, are investors getting paid for the amount of risk they are taking. And second, what kind of loan recoveries should we expect in the next downturn.

The question of recoveries has kept market observers and rating agencies occupied for a while. As our *Chart of the Week* highlights, both first and second-lien term loan recoveries are expected to suffer relative to 2008-2009. Second-liens in particular will erode dramatically, according to Moody's.

In part, that's due to higher leverage. With some structures topping out well over six times ebitda, (and in some cases, seven), the case for a reasonable recovery for second liens weakens. After all, in a downturn, the enterprise value of many distressed borrowers could dip into the fives (as a multiple of ebitda), or lower.

Worse second-lien recoveries are also due to a growing trend of intercreditor terms favoring firsts over seconds. For example, the issuer's ability to incur incremental first-lien debt can erode the ability of second-lien holders to extract full value.

Loan recoveries are affected by additional factors, such as size of the issuer, sector, whether the loans lack maintenance covenants (cov-lite), and whether the first-lien term loans have seconds or true subordinated debt underneath them.

Next week we'll take a look in more detail at some of these elements.