What's Leverage Got To Do With It?

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A persistent misunderstanding in leveraged lending is using leverage as the sole metric for market frothiness. Drawing such conclusions is like judging an episode of *Keeping Up with the Kardashians* by the first two minutes. That takes at least three minutes.

It's tempting, of course, to be carried away by the headlines. Both Thomson Reuters and S&P LCD have highlighted in recent months how this year's loan market has featured more loans with leverage approaching that of 2007 transactions.

To illustrate the point, see our *Chart of the Week*. Almost 55% of LBOs this year have sported leverage, defined as total debt-to-ebitda, over six times. Compare that to 56.7% for the pre-crisis, market topping level in 2007.

Similarly, S&P is reporting recent large cap LBO leverage of 6.6x. Yikes!

Missing in this analysis, though, is equity contributed as a percent of overall capital to these buyouts. The latest data (per S&P) show sponsors contributing on average almost 35% of the target's balance sheet in the form of equity. That's up from 2007's 30%.

Veterans of the pre-meltdown market have also noted that today's share of less-than-20% equity to capital transactions is *de minimis* relative to the prior bull loan market.

What also gets ignored is that investors look at leverage on a deal-by-deal basis, not as market averages. So many variables go into debt capacity analysis. What industry are we talking about? Putting six times debt on a market leading software manufacturer that demonstrated double-digit annual growth through the recession is one thing. Doing the same for a transmission supplier is something else.

S&P tracks performance by sector in great detail. Depending on where companies fall on the cyclicality spectrum, leverage varies considerably. Metals and mining transactions – at one extreme – average less than four times total leverage. Deals in the auto sector are slightly higher, at 4.25x. Compare those levels to large cap media issuers (over 5.00x), and business service firms (5.25x).

Ebitda size is a major factor in how much debt a company can handle. It's one thing for a sponsor to lever up a $250 million ebitda business in a defensive sector six times, but you can't treat a $25 million company that way.

Another big credit factor is free cash flow. Highly leveraged issuers that can delever quickly from ethereal heights give investors comfort they won't stay at lofty debt levels for long. Businesses with high capex characteristics will be scrutinized very carefully.

What's the structure of the debt? Is it a unitranche, or is there patient junior capital underneath a senior TL and an asset-based RC? Lenders who feel protected are much more willing to stretch than those whose downside case puts them more at risk.

Leveraged loan data are extremely helpful in understanding where we are relative to the market's historic performance. But it's issuer-level information that drives individual investor decisions. And for good asset managers, that's all that really matters.