Second Thoughts (Last of a Series)

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It's hard to know exactly when second-lien term loans first appeared in the leveraged loan market. According to S&P's Loan Primer, they showed up in the mid-1990s, as the institutional market grew, and then vanished with the Russian debt crisis of 1998.

Our suspicion is these structures evolved from "over-advance" facilities in conjunction with asset-based loans, which were secured by priority liens on the current assets.

Regardless, the first such syndicated instrument to stand out in our memory was as part of J.W. Child's financing of the acquisition of *NutraSweet* from Monsanto in March, 2000.

Led by Deutsche Bank, the $360 million financing consisted of a five-year $50 million RC, a five-year $100 million term loan A (sold to the banks), and a seven-year $160 million term loan B (sold to institutional investors). These facilities were collateralized by first-lien security interests in the assets of the company.

What caught our attention was the final tranche: a $50 million second-lien term loan with an eight-year maturity priced at L+512.5 bps. That pricing compared favorably to the TLA and TLB, priced at L+287.5 and 350, respectively, and was seen as helpful in compensating for the longer tenor and junior collateral position.

From a credit perspective, while the company had strong cash flow characteristics, it was also replete with fixed assets and quality inventory and receivables. Intangible assets such as trademarks were also included in the collateral package.

A decade and a half later, that type of relative value analysis on deals continues. In not all cases, however, can lenders look to asset protection as an alternative source of repayment.

The resurgence of the second-lien institutional investor since the end of the credit crisis improved liquidity in the asset class. But as our *Chart of the Week* illustrates, it also dampened spreads as more cash flowed into the space. Additionally, the envelope was pushed on deal leverage and terms.

For those buyers, whether BDC, credit opportuity fund, hedge fund, or even CLO and mutual funds, the question is how far are they willing to be pushed?

As we discussed earlier in this series, market volatility took a toll on second-lien volume in the latter half of 2014. But the history of this asset class – indeed, most investments – is that eventually a clearing price will be found. At that point, we expect yield investors to come back into seconds with vigor.

Meanwhile, and probably for the next quarter or two, second-liens will be featured in larger syndications, where arrangers can entice funds to take a slice of second for more favorable allocations on firsts.

For smaller middle market deals, particularly with sponsors having historic mezzanine relationships, look for unsecured junior capital to play an increasingly significant role.

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