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Why Credit Standards Matter (Second of a Series)

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The response to last week's column, as we initiated our special series on the state of credit standards in the leveraged lending market, was heartening. Readers enthusiastically supported the notion that industry players need to be reminded of the basics of credit risk and why it's critical to stick to the fundamental tenets of sound underwriting practices.

One reader reiterated the call for more scrutiny of today's components of cash flow. "You articulated for all of us," he wrote, "the importance of the concept of 'quality Ebitda.'" Another related several deals she had seen recently where the definition of Ebitda was almost comically distorted. "One model showed cash flow adjusted for *future* revenues from a new customer." She laughed. "You can't repay debt with phantom Ebitda!"

The absence of contractual amortization was another hot topic. "The problem is that senior lenders long ago gave up the ghost on getting repaid," one veteran credit pro wrote in a note. "They forgo real amortization and deceive themselves by thinking ratio de-leveraging is the same as actually paying down debt."

The concept of "net debt" got a healthy going over from several sources. "Why do lenders still allow accumulated cash to be counted against debt for covenants?" a risk manager asked rhetorically. "When cash flow evaporates, what do you think happens to all that cash?"

Cash flow recaptures were the target of some of the more critical observations. "It's fine to have a sweep if it works," said a lender. "But as an industry we've allowed all sorts of manipulation using time delays, carve-outs and definitional slipperiness on the concept of what excess cash flow really means."

From a market perspective, the cash flow sweep percentages have also diminished since the credit crisis. The standard for middle market credits was 75% of excess cash flow going to repay debt (see *Chart of the Week*). Like other "big boy" terms – large cap covenants migrating down to smaller issuers – 75% now steps down to 50% once total leverage reaches a given level.

In some cases, step-downs are set to trigger within a quarter or two from the closing of the transaction. In others, the recapture is entirely eliminated. And that trigger point, like leveraged covenants in general these days, is being set higher and higher.

Of course back-ended term loan B amortization (another middle market feature borrowed from the large cap institutional market) was palatable because sweeping excess cash would repay the debt. But with such recaptures essentially neutered, leveraged loans have become bullet loans.

That's fine if excess cash flow definitions have real teeth. Otherwise, it's like sweeping the floor with a wet noodle.

Next week: our series on credit standards continues with a review of credit fundamentals