Payback Time

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One bedrock tenet of sound lending practices is establishing the borrower's capacity to repay its debt over the contractual life of the obligation. So it's not surprising that regulators have taken banks to task in recent reports highlighting a growing number of leveraged loan issuers which lack that capacity.

Specifically, in its 2014 Leveraged Loan Supplement, the Gang of Three – Federal Reserve, OCC, and FDIC – cited banks in which only 77% of portfolio companies managed to show they could successfully amortize the loan over a seven-year period. That was down from 83% measured in the prior year's examination.

Projected cash flows should indeed leave plenty of room for principal and interest payments. But a bit of perspective on the topic is in order.

To paraphrase F. Scott Fitzgerald's observation about the rich, leveraged borrowers are different than other borrowers: they have more debt. Private equity sponsors use leverage to enhance their returns, and not every business is a good candidate for high debt levels. Premiums are paid for companies that demonstrate significant free cash flow generation.

The buyout industry has spent decades developing a base of sophisticated credit investors willing to take the risk – and earn the high returns – involved with these loans. Given many of these buyers match-fund their long-term assets and liabilities, they don't want to get paid back – at least, not too quickly.

It was precisely to accommodate these funding requirements that bank loan arrangers created the "term loan B" product in the early 1990's. Crossover investors from high-yield bonds were accustomed to a lack of amortization, so payments were back-ended with balloons in the final two years, and just enough interim installments (for example, $250,000 quarterly) to meet funds' average weighted life tests.

Payback schedules are often moot. Leveraged loans are governed by excess cash flow recaptures, which apply cash generated above and beyond mandatory uses (such as capex) to repay principal. So these borrowers often deliver more quickly from periodic sweeps than from scheduled amortization.

Private equity shops buy companies to sell them – often within seven years. Sponsors also like tweaking debt structures. Whether to refinance on better terms, provide for an acquisition or merger, or recap for a shareholder dividend, original PE financings rarely survive untouched to final maturity. Any recalcitrant banks often get the opportunity to exit along the way.

We appreciate regulators' concerns about "risky loans" that don't seem to get repaid, but the vast majority of these loan buyers (88.5%, at last count) aren't banks. Mutual funds, CLOs, hedge funds, and insurance companies like assets with longer maturities. Having to redeploy returned cash is an expensive nuisance.

Yes, loan arrangers hold significant chunks of institutional loans during the early syndication process, and regulators worry about banks getting hung with these deals if markets turn. But underwriters have learned the lessons of 2008. Today the overhang of unsold loans is a fraction of what it was before the crisis.

In thirty years we've helped finance hundreds of leveraged loans and seen only a handful go full term. Ironically, those few were among the less successful investments of our private equity clients. But lenders care less about return *on* principal, than return *of* principal.