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Payback Time – Readers' Say

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Our mailbag was overflowing in response to last week's column on the topic of repayment trends in leveraged loans. Readers mostly bemoaned the lack of discipline by lenders in compelling borrowers to reduce debt in the form of real amortization.

We considered how quaint the notion has become of borrowers actually repaying debt over the contractual life of the obligation. Institutional credit investors are congenitally disposed to accepting back-ended paybacks, in part, we noted, due to the match-funded nature of some investors' long-term assets and liabilities.

One banker scoffed at this notion. "The match funding argument is a bit of a red herring," he stated. "The vast majority of leveraged loans are floating rate, so the lack of amortization is an accommodation to sponsors rather to the funding needs of lenders."

Another focused on market practice that relies on excess cash flow recaptures, in lieu of scheduled amortization, to reduce leverage. "The implication sweeps have provided quicker pay downs than seven-year amortization schedules is questionable," he wrote.

"Not to mention," he continued, "as you pointed out, lenders have eviscerated sweep mechanics by using elaborate carve-outs, definitional sleights-of-hand, timing delays, and performance based step-downs."

A third risk manager remarked: "Having to redeploy returned cash may be an expensive nuisance, but when things hit the fan, it's a fraction of the expense and nuisance of having to eat a big loss rather than absorb a much smaller one."

To a large degree the relaxed attitude toward loan repayment has followed the growth in liquidity, especially in broadly syndicated loans. The operating assumption is that lenders can trade out of a position with little loss of principal at the first sign of trouble.

This may be true of large liquid loans, but is less true for the middle market. We sought out a former mid cap risk officer for his view of the matter; namely, how to deal with the problem of lack of true amortization.

"A key discipline is to analyze refinancing risk," he told us. "A good tool is having a well-defined 'Base Case'. If the borrower is projected to have more than 35% of the original amount still outstanding in the year before final maturity, you need to demonstrate the balloon payment can be refinanced under very conservative assumptions."

Of course this assumes a reasonable definition of cash flow itself. As we've covered elsewhere what constitutes Ebitda has, in many cases, been so altered by adjustments and other dilutions that it is rendered almost unrecognizable from actual Ebitda.

Our favorite comment came from a wise veteran of the middle market. "I'm a cash flow lender," he told us at a golf outing this week, shaking his head sadly. "It would be nice if I got to see some real cash flow once in a while.”