

Why Revolvers Matter

THE LEAD | July 8, 2015

It's been called the most mispriced security on Wall Street. It's also the least-known casualty of bank regulatory reform. Welcome to the revolving credit facility.

For decades the workhorse of commercial financing, a revolving credit operates like a credit card supporting a corporate borrower's receivables and inventory. It's typically made available by commercial banks in the form of small undrawn facilities, usually between \$2 and \$10 million for mid-market borrowers.

Private equity-backed companies use RCs for similar purposes, including small acquisitions. No one paid much attention to them until recently. What's changed? In three words: Leveraged Lending Guidelines.

Since regulators' crack-down on "risky loans," banks have been reducing their funded debt exposure to the most leveraged issuers. As that occurs, non-banks are stepping into the void, and are being asked by PE sponsors to provide the same undrawn capacity to borrowers that banks hitherto allocated effortlessly on their balance sheets.

Non-banks are discovering that this pedestrian financing tool, once an afterthought in leveraged buyout financings, is anything but effortless to deliver. First, there's the cost of capital. RCs for leveraged borrowers can be drawn at any time, yet the 50 bps commitment fee typically charged on the undrawn amount is a fraction of funded loan spreads.

RCs are also labor intensive. Companies may borrow and repay frequently and employ various interest rate options. If there's a lending syndicate, the agent must track each participant's share. There are fees for this, but it's rarely a money-maker since considerable back office support is required.

Being able to provide RCs has become a key differentiator in winning buyout financings. New debt platforms are entering the leveraged loan market with ingenious credit solutions, only to discover that what issuers are looking for is good old-fashioned revolving credit.

Attempts have been made to solve this puzzle. After the 2000 internet bubble a few intrepid lead arrangers essayed charging higher commitment fees to cover the cost of standby liquidity. Instead of 50 bps, they boosted fees to 125-150 bps. But this experiment failed as liquidity swept into the market and undrawn fees fell back to 50 bps, where they have remained ever since.

Other approaches have been tried. One variant is the delayed-draw term loan. This tranche is available to be drawn down in stages for a period up to 18 months after closing, and then termed out over five years. DDTL's cannot usually be repaid and re-borrowed.

Lenders have also exerted pressure on issuers to settle for smaller RCs – just enough to handle occasional working capital shortfalls. But competition for lead business remains fierce. To make matters worse, sponsors are demanding outsized revolvers for acquisitions, capital expenditures, even dividends.

Would-be agents must face the fact that providing RCs is a reality of leveraged lending. Success will mean somehow cracking the code of providing immediate and flexible capital availability at a competitive cost.

Perhaps somewhere out there is a new investor class eager to take on just this type of obligation.

This column first appeared in the weekly newsletter of [Creditflux](#), a leading global information source for the credit trading and investment market.