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Labor Day Countdown

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News last month that the New Horizons spacecraft zipped by the former planet Pluto at 36,373 mph, snapping pictures as it went, drew raves from the rocket science community. Our attention was taken by one ironic fact: the probe's generator runs on plutonium.

Rare elements were much on our mind as we've tracked the paucity of new buyouts in the leveraged loan pipeline heading into the last weeks of summer. And those deals we're seeing are a mixed bag in terms of quality.

For one thing, total leverage seems again to be reaching radioactive levels. Thomson Reuters LPC reports total debt to Ebitda for middle market institutional buyouts "skyrocketed" to 6.5x for the third quarter. Admittedly, that's on a relatively small sampling, but the statistic points to a broader trend.

Higher leverage is being driven by similarly gravity-defying purchase price multiples. Of the four middle market LBOs where information is available, all were over 12x, and three were over 15x. This speaks to the fierce competition for new properties being engaged in by both private equity and strategic corporate buyers.

The good news for lenders, as our *Chart of the Week* highlights, is that private equity sponsors are putting in higher proportions of cash equity into transactions. At close to 55% of equity to capital, that's as lofty a debt cushion as we've seen in recent memory.

One veteran leveraged participant was not impressed. "That just means there's more money for the sponsor to flush when things go bad in a downturn," he sniffed.

Nevertheless, the continued imbalance of deal supply and investor demand is perpetuating frothy lending conditions. This exuberance is sending some deal terms into higher orbits of looseness, particularly on covenants and debt baskets.

At a recent meeting of lenders, a long-time credit manager related one such case, regarding a liberal add-back definition. "The company added back revenue from a customer they had lost," he said. "But management felt they should win it back soon."

As participants look to the post-Labor Day pipeline, the seesaw between loan sellers and buyers may be headed for a reset in favor of the buy-side. Middle market investment banks report record levels of M&A pitch activity which normally jumpstarts more financing opportunities.

That should help offset the structural laxity and spread tightening we've witnessed this summer. Experienced asset managers recognize when to pass on riskier deals, knowing the pendulum always swings back.

With more supply to choose from, lenders should start to act like thoughtful investors, rather than bankers from Mars.