A Loan for All Seasons (Third of a Series)

THE LEAD | June 28, 2023

"Leveraged loan default rate rises to 14-month high in May"

"US loan default rate hits 3-year high"

"Defaults in private credit averaged 5.9% in 1Q, law firm says"

Everywhere you look these days industry rags are filled with talk about looming loan defaults. For anyone who's been a practitioner or observer of the debt capital markets for more than a couple years, the above headlines are familiar ones. They could have been yesterday's news.

Well, they are yesterday's news. These headlines are all from the archives of our content partner Pitchbook LCD, dated June 2016, March 2018, and May 2020, respectively. You can find nearly identical ones in their current headlines. The truth is that defaults are a fact of life in leveraged lending. As a manager, the question is how you deal with them.

But first it's important to understand not all defaults are created equal. Our friends at Lincoln International recently published their data tracking "defaults." A news agency picked up the note (*"Defaults of private loans continue to increase, ticking up to 4.5% in the first quarter…"*). The only problem is that these were financial *covenant* defaults, not payment defaults.

There's also a fundamental difference in how payment defaults arise in broadly syndicated loans versus direct lending. Since nearly all liquid loans lack maintenance covenants, lenders are challenged to protect their positions if borrower performance deteriorates. Yes, they can sell the loan, assuming it's before the negative news gets out.

By contrast, most middle market loans have covenants, and in the current environment those covenants may include interest or fixed charge coverage tests. And those tests are structured tighter than ever to projected financials. So a modest miss on quarterly numbers can quickly position lenders to have constructive conversations with owners about remediation.

Part of the persistent default myth is defaults are bad. But experienced private credit managers know they can be triggers leading to enhanced positions in capital structures. Defaults are not necessarily the drivers for middle market portfolio performance. It's all about losses.

Direct lenders deal with default events in much different ways than banks historically did (and arguably, still do). Regulated entities are penalized with higher capital costs for criticized and classified assets that motivate quick moves off their balance sheet. That can destroy loan value.

Two decades of data show private debt losses lower and recoveries higher than BSLs or high yield bonds. Why? Middle market companies with operational difficulties need time to right themselves. Having small, relationship-driven, buy-and-hold lender groups aligned with sponsor owners helps restore cash flows and value. To minimize losses, it’s not how you start, it’s how you finish.