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What Brexit Means for Loans

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"Thank God for the Electoral College." Thus the co-head of a major credit trading desk put a brave face on the US political outlook after last week's stunning Brexit vote.

And while the wisdom of our Founding Fathers may shield us from a similar upheaval in the direct popular vote for President, there's no guarantee that past party precedence in the electoral vote won't end up with the same surprising turnabout.

Beyond trading and currency turmoil, there was little certainty of what other immediate financial fall-out would accompany the "Leave" outcome. Equities have taken a hit, though most selling was due to dealers reluctant to hold positions over last weekend.

High-yield bond prices, the most sensitive of credit instruments to bad economic news, traded off a few points, but otherwise shrugged off events in Europe. Same with broadly syndicated loans; prices were generally "quoted lower" as buyers searched for bargains. Sellers sought clarity amid uncertainty.

What was clear was that whatever lies ahead for the UK and EU will not be resolved soon. Debt arrangers had kept pipelines light in expectation of the vote. If pending deals clear without tears, issuers will be emboldened to venture forth, albeit at a cost.

What impact will Brexit have on loans, and in particular, middle market loans? For one thing, volatility has returned to the market. That's good for investors. As we saw last August, this means higher spreads, lower secondary prices, and tighter structures. For another, as Thomson Reuters has noted, the syndicated loan market is a dollar or euro market, so is naturally cushioned against pound sterling shocks.

For issuers, it's a mixed bag. As one sales pro told us, "Volatility clouds visibility." Repricings are off the table for the present. So are the tougher credits. But the buy-side is still flush with cash. That means there's room for good deals to get done.

And the Fed is likely done with rate hikes this year; indeed, its next move may be *down* (see *Chart of the Week*), creating continued appetite for yield. As one loan manager suggested, "Brexit gives accounts a second chance to take advantage of the market."

Economists are issuing downward GDP revisions for the UK (drastic) and EU (less so). Adjustments to the US have been minimal. That points to a strength of middle market credit. Those issuers have largely domestic revenues with less European exposure.

Another Brexit upside for private credit investors is that larger banks are likely to back away from the middle market syndicate game. Gone with them are cov-lite for below $50 million Ebitda issuers and more aggressive debt baskets.

Not long ago we published a series on the challenges of direct lending in Europe. One experienced manager noted the hurdles created by jurisdictional differences. “Europe is not a market,” he told us. That certainly resonates even more today.