Deep Dish

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Xavier University announced last week the installation of the nation's first pizza ATM. The $55,000 machine's capacity is 300 medium-sized pies a day, with orders taking three minutes from refrigerator to cardboard box serving. Preparation for the dining hall staff consisted of "40 hours of training each from a French chef."

Besides restoring our faith in the priorities of American higher education, this story echoed the dubious quality of deal flow being vended in the leveraged loan markets.

Just as the remaining swigs of your favorite Bordeaux are bound to include some bitter dregs, the August doldrums have saddled loan buyers with some cheesy fare. For one thing, smaller issuers are rampant. Companies with less than $10 million in ebitda are out seeking financing on terms that rival those of much larger borrowers.

This is particularly true of leverage. While 3-ish times senior debt to ebitda and 4-ish times total debt seem like reasonable metrics, an issuer that is stretching to reach double digits cash flow could easily drop back to mid or low single digits with the loss of a major customer, a production facility going off-line, or simply margin pressures.

These companies are typically financed by a discreet segment of lenders who understand the higher risks associated with lower ebitda, and receive appropriately higher compensation. To the extent smaller deals find their way to more traditional middle market lenders, the hit rate will probably be significantly lower.

Another manifestation of below-standard transactions are borrowers with hockey stick performance over the past several years. A good example are companies in faster growth consumer branded products. The consumer represents one of the few bright spots in the post-crisis economy. Some products have latched on to popular trends and ridden them to sharply higher revenues.

That's great except that in the face of intense competitive pressures, private equity buyers are compelled to bid at lofty multiples of annualized cash flows. Then, of course, debt arrangers are similarly pushed to offer leverage off those same numbers. If the company's performance falls back to historic levels, leverage will skyrocket.

Tough sectors are also a challenge. Besides the obvious energy-related concerns, we've seen deals in the commodities, retail, construction, and printing spaces that make for difficult underwritings in today's economic environment.

As our *Chart of the Week* shows, this year's large cap leverage loan pipeline has struggled to keep pace with 2015 levels. But for both the broadly syndicated and middle market product, there are signs of life as September draws near.

In the meantime, debt investors are gamely putting the best face on some less-than-appetizing product. We suggest a cautious approach to these opportunities. A bad deal is a bad deal no matter how you slice it.