CLIENT ALERT

Loan Market Trends

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Pricing a stressed loan in the secondary market is harder than ever these days. In normal times, when investors evaluate loans of companies with financial or operational problems, they assume those problems can be fixed with tactical contributions of capital or management know-how. Pricing a loan meant estimating the current value of the loan, adding the cost of improvements required to fix the borrower's business and then discounting the sum to a present value that rewarded the investor's risk and cleared the market as a trading price. That template doesn't work perfectly in today's market, where some great businesses aren't broken but the demand for what they sell has suddenly vanished. More than ever, buying a stressed loan requires an investor to express a strategic view about how today's economy will evolve, and when the "new normal" will materialize for the borrower's business. How will the energy, metals, mining, retail, airline, automotive, restaurant or hospitality sectors be re-fashioned in the next eighteen months? Buyers must take a broader view and calculate the cost of the transformations necessary to ensure the borrower will survive in the new macro-economy, which is a complex calculus.

Buying a loan at the right price also means keeping an eye on several micro-trends that affect the loan product directly. In particular:

- Have historical recovery assumptions changed for defaulted loans?
- Are distressed loans trading on distressed documents?
- Will borrowers change existing credit agreement terms by manipulating required lender consents?
- Is the loan freely transferable (can it be bought and sold without legal friction)?
- If CLOs control more than half of the loan market, how will they influence lending syndicates when navigating the next wave of borrower defaults?

Reduced Recovery Rates

For 30 years, markets have assumed an average recovery rate of 80% for a defaulted senior secured loan. Many factors supported that robust recovery rate, including sound underwriting practices, overcollateralization and the continued development of legal principles favoring secured creditors' access to collateral. Credit structure and rank were the most important considerations influencing recoveries, and on average, defaulted secured loans recovered twice as much as defaulted high-yield bonds. The 80% recovery rate became a cornerstone of distressed investing and gave investors the courage they needed to buy the debt of bankrupt companies. But analysts are now concerned that a 60% (or lower) recovery rate could be the new average recovery rate for defaulted secured loans. The potential decline is tied to the rise of "cov-lite" loans, which, while still secured, include weaker (bond-like) borrower covenants. Cov-lite loans now account for 80% of all leveraged loans in the US market. They were purchased by institutional investors searching for extra yield in a low interest-rate environment. Those investors were willing to sacrifice comprehensive protections traditionally demanded by secured creditors (including covenants to maintain interest coverage ratios, make mandatory prepayments from asset sales, strictly preserve a collateral pool, limit investments in, and transfers to, subsidiaries and affiliates and limit pari-passu senior debt), in exchange for higher yields. Without the discipline imposed by covenant-rich loan documentation, lending syndicates will have less leverage to bargain with distressed borrowers – waivers won't be needed for covenants that don't exist – and cov-lite lenders will have far less ability to influence a distressed borrower's behavior prior to an actual payment default. If value leaks from the borrower's enterprise because secured lenders were unable to intervene at key inflection points, then recovery rates will decline. In today's loan market, buyers will consider haircutting stressed cov-lite loans accordingly.

Distressed Purchase Agreements

The secondary loan market trades under two broad documentation categories: par and distressed. Par documentation transfers loans on an "as is, where is" basis, while buyer-friendly distressed documentation requires sellers to provide important protections to buyers of the loans of stressed companies. There is no set price point at which the trading convention shifts from par to distressed. In theory, the market itself "decides" when a borrower's prospects make the additional protections afforded by distressed documentation relevant and practical. The Loan Syndications and Trading Association (LSTA) administers a "shift date poll" that is designed to identify a specific date in the past when dealers first traded a credit on distressed documentation. However, many buyers misinterpret this backward-looking guidance as a signal they should "start" using distressed documents, when in fact the protections provided by distressed documentation would have been valuable earlier in a borrower's downward trajectory. Accordingly, many buyers miss an easy opportunity to obtain robust representations, warranties and indemnities from sellers of distressed loans. *This misinterpretation of the shift date poll has created paralysis: it is as if the market were standing on a corner waiting to cross a street, while watching a traffic light designed to turn green only when people start crossing the street*. The glitch has resulted in stressed and distressed credits trading on par paper, a mismatch that is getting worse as more borrowers become stressed. Fortunately, the LSTA has recently asked for comments to the shift date rules, and it is possible that the confusion around the poll will be resolved as distressed trading volumes increase in the coming months. The ability to purchase a loan on using distressed documentation should be a positive factor in any pricing template.

Gamesmanship Around Lender Control of Amendments

Credit agreements set voting thresholds for approvals of corporate actions affecting the borrower. The recent news about Revlon, Inc.'s dispute with its lenders shows how important those thresholds can be. According to the financial press, Revlon needed additional liquidity and agreed to borrow $880 million under a new, 2020 credit agreement. Although the new loan required consent of a majority of lenders under the 2016 credit agreement, slightly less than a majority of the 2016 lenders supported the amendment. Revlon then exercised a right to issue a new tranche of revolving commitments under the 2016 credit agreement, allegedly ensured the new tranche landed in friendly hands and included the new lenders in the vote, which then succeeded. Dissatisfied lenders now contend that the "sham" revolving commitments were issued solely to overcome the vote of the original majority lenders, and indeed, the revolving commitments were structured to vanish shortly after the closing of the 2020 credit agreement. The lenders argue that the vote permitting the amendment to the 2016 credit agreement should be considered void. This is another example of gamesmanship around strategic amendments, collateral shifting and required consents. The borrower/lender chess match will continue, and the evolving issue for loan investors will be: "do lenders really control the modification of credit agreement terms – is it clear that the structure, rank and collateral of the loan can't be modified in the future without required lender approval?" An uncertain answer makes accurate pricing more complicated in today's market, especially because borrowers will need more amendments to credit terms as their businesses urgently transform.

Borrower-friendly Transfer Restrictions

Credit agreement provisions that permit lenders to sell down their loans have become more restrictive, giving borrowers more control over the future composition of the lending syndicate. In addition to allowing borrowers to deny consent to new lenders in more situations, credit agreements now contain lists of deemed “disqualified lenders” and “white-listed (permitted) lenders”. At the same time, the scope of prohibited transfers has been extended beyond plain-vanilla “assignments”, to transfers by participation, sub-participation, swap and other legal structures. While the restrictions are intended to ensure a borrower-friendly syndicate, they also reduce liquidity for the loan product. In the European loan market, many credit agreements prohibit transfers to “loan-to-own investors” – funds whose principal or primary business involves purchasing loans with an intent to gaining control of a borrower’s business. Apart from the difficulty of interpreting and applying these types of ambiguous limitations in real time, borrower-friendly transfer restrictions impair liquidity at exactly the wrong time in the credit cycle. Distressed investors, whether “loan-to-own”, “disqualified” or otherwise characterized, may be the only buyers with a bid in the market when lenders need to sell a stressed credit.

CLOs on Autopilot?

Collateralized loan obligation trusts dominate today’s leveraged loan market. Senior tranches of CLOs performed well through the 2008 global financial crisis, and today CLOs hold more than half of the $1.2 trillion loans in market. These structured vehicles are designed provide a waterfall of payments to tranches of notes and equity sorted by risk-adjusted return profile. Professional CLO managers earn their keep by providing the high-touch and labor-intensive expertise necessary to preserve value for investors across hundreds of loans. CLO managers vote on restructurings, waive covenant defaults, agree to amendments and otherwise manage the legal and operational details of a diversified portfolio of loans, while simultaneously managing complex indenture and portfolio balancing requirements. But if CLO loan portfolios deteriorate and too many loans are downgraded, then those lower-rated loans must be marked to market, rather than carried at par, and the CLO risks failing crucial tests designed to ensure the structure is over-collateralized. If the CLO fails these tests, then payments to lower tranches of the structure may be suspended, and on-going fees paid to CLO managers may be substantially reduced. Loan market participants worry that if CLO managers are required to downsize their operations, then their large portfolios of loans will suffer from lack of active management. CLO managers may be unable to react to a steady stream of issues, from simple forbearance agreements to urgent financial restructurings, arising from hundreds of loans caught in a market-wide downturn. Anything less than a full commitment to the loan product by CLO managers will amplify the risks of guiding a distressed credit to the new (or next) normal and this concern adds further uncertainty to today's pricing decisions, especially when CLOs represent a substantial portion of a distressed borrower's lending syndicate.

We expect that macro-economic and micro-loan-product trends will continue to influence the leveraged loan market in ways we can’t fully anticipate now. We look forward to updating our clients and friends about these and other loan market trends in the future.

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