Market Trends 2017/18: Leveraged Finance

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

The year 2017 continued the trend of growth in the leveraged finance market consistent with prior years. The record levels of loan volume were in part driven by strong investor demand which significantly outpaced supply. In contrast to 2016, which saw the market concerned with the evolution of the leveraged lending guidelines, the prospect of rising interest rates, and the outcome of the U.S. presidential election, the leverage finance markets in 2017 proved to be largely unaffected by these issues as a strong and steady stream of loan issuances continued to come to market. The leveraged loan market continued to be supported by high volumes of collateralized loan obligation (CLO) issuances and yield-seeking investors in the loan asset class.

The Board of Governors of the Federal Reserve System's (Federal Reserve's) target short-term interest rate hike cycle continued in a steady and predictable fashion in 2017, with the Federal Reserve remaining transparent in communicating its plans. This key rate was raised three times in 2017 (by 0.25% each time) and continued that trend early in 2018 under new Chair Jerome Powell with another 0.25% increase in March 2018 resulting in the current benchmark rate standing at 1.75%.

Nonetheless, there were a number of developments in 2017 which may impact the market in the years ahead—three of the most important concern the enforceability of the leveraged lending guidance, the eventual replacement of the London Inter-bank Offered Rate (LIBOR), and the effects of the enactment of President Trump's tax reform plan.

In 2017, market practices became more established under the "Interagency Guidance on Leveraged Lending" (the Guidance) issued in 2013 by the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), as the bounds of acceptable practices became clearer. However, in October of 2017 the Government Accountability Office (GAO) determined that the Guidance was a rule, and not guidance, for purposes of the Congressional Review Act (CRA). Under the CRA, as a rule and not as guidance, the Guidance should have been subject to a 60day congressional review period and because it was not, the current enforceability of the Guidance was called into question. In response to the resulting concern, the Federal Reserve, FDIC, and OCC suggested that they would consider reopening the Guidance for public comment and possible refinement. Although some banks pursued deals with more aggressive leverage levels against this backdrop, most adopted a wait-and-see approach, choosing to maintain leverage within the realm of the Guidance's established 6.0 times standard (i.e., ratio of debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) of 6:1). However, things continued to become clearer in 2018 with Joseph Otting of the OCC reporting to have noted at a conference presentation that "Institutions should have the right to do the leveraged lending they want, as long as they have the capital and personnel to manage that and it doesn't impact their safety and soundness."

Direct lending by unregulated entities continued to grow in 2017. In the years since 2013, direct lenders have become an important source of capital in the leveraged finance market, particularly for smaller corporate and mid-tier sponsors in proposed transactions that may have been inconsistent with the Guidance. Direct lenders are continuing to gain access to top-tier sponsors and even public companies as they further embed themselves as a source of capital in the loan market by offering favorable loan terms.

Another regulatory development that will require attention in the years ahead is the announcement in July 2017 by the United Kingdom's Financial Conduct Authority that banks would no longer be required to submit LIBOR quotes beginning in 2022. However, banks agreed to continue to support LIBOR through 2021 so there will be time for the market to develop an alternative approach. Borrowers and lenders have been actively reviewing their existing LIBOR fallback provisions and amendment provisions to ensure an alternative to LIBOR can be established if and when LIBOR ceases to be quoted. Further, there is no market consensus yet on a replacement for LIBOR which raises a number of issues that will need to be dealt with in the coming years.

In December of 2017, President Trump's much-anticipated tax reform plan was enacted through a bill informally known as the Tax Cuts and Jobs Act (TCJA). Certain provisions of the TCJA that may affect leveraged lending transactions include the overhaul of the Section 956 deemed dividend rules, the 30% limitation on interest deductions, and the reduction of the corporate tax rate from 35% to 21%. Market participants continue to consider the implications of these new tax provisions as they document and structure new deals. As detailed below, the limit on interest deductions will likely have an immediate effect on the financial performance of certain highly leveraged companies.

Despite the above, 2017 was characterized by a lack of volatility coupled with demand (particularly institutional demand) that far outstripped supply causing leveraged loan volumes across the board to reach all-time highs. Globally, syndicated lending reached $4.3 trillion, an 8% increase from the prior year, largely driven by $2.5 trillion of U.S. syndicated loans. U.S. leveraged loan lending increased by a reported 60% to $1.4 trillion, setting a new record. This increase in activity was driven by $919 billion of institutional loans, which made up two-thirds of leveraged loan volume in 2017. This volume was largely a result of strong investor demand for yield. Of the $1.4 trillion total amount, refinancing activity accounted for $933 billion, beating the previous record set in 2013 by 23%, as issuers were able to cut lending costs and get better terms in the borrower-friendly market. New money dropped to one-third of volume in 2017, having accounted for 47% in 2016. By industry, technology, financial services, general manufacturing, and healthcare continued to be the most active. In the fourth quarter of 2017, average leverage levels rose to 6.5 times EBITDA for broadly syndicated leveraged buyout (LBO) transactions and 5.9 times EBITDA for institutional middle market LBOs.

Among the most notable trends in leveraged finance in 2017 was the continued dominance of refinancing activity from the prior year. Outside of refinancing activity, mergers and acquisitions (M&A) loan volumes began the year slowly but finished solidly with leveraged issuance increasing 15% to $311 billion. This volume was driven by $126 billion of LBO issuance, which is 44% higher than 2016 and second only to 2007's pre-crisis issuance levels. Leveraged sponsored volume also increased to $701 billion, almost double the previous year's volume.

CLO issuance broke with expectations finishing 2017 with over $117 billion in volume, a 62% year-over-year increase and second only to 2014's record issuance number of $124 billion. CLOs are the largest buyers of leveraged loans, and the strong demand from CLOs helped create market conditions favorable to refinancing transactions.

With respect to the bond market, after declining for three consecutive years, issuance in the high-yield market jumped 24% to $281 billion in 2017. Unlike 2016, this volume was skewed toward higher-rated bonds with 46% rated between BB+ and BB- and 39% rated B. Although the high-yield market did increase in 2017, issuers have demonstrated a preference for loans—even when considering only covenant-lite loans (i.e., loans with incurrence covenants only). In 2017 covenant-lite issuances exceeded high-yield activity by 41%.

The remainder of this article will focus on some notable deals of 2017, current practices with respect to deal structure and process, deal terms that are currently among the most heavily negotiated, legal and regulatory trends, and the outlook for 2018.

NOTABLE TRANSACTIONS

The year 2017 saw an increase in total number of deals, but a decrease in average deal size, with volume driven by the number of deals rather than by the size of the transactions.

Refinancing activity was the primary driver of the record volume of leveraged loans in 2017, with tech firms leading the way. Dell twice repriced term loans due September 2023, which were originally issued in June 2016, via a Credit Suisse-led six-bank arranger group. In addition, Dell also secured two other term loans for $4.45 billion and $1.8 billion, respectively, as part of a refinancing effort. Charter Communications and Sprint were also very active in the refinancing market each with issuances aggregating in the billions.

A significant portion of the volume was also attributable to acquisition financing. For example, CenturyLink incurred a $6 billion term loan facility in connection with its acquisition of Level 3 Communications. A Blackstone-led acquisition of Tempo was a notable acquisition financing on the sponsor side.

The high-yield market was also characterized by many smaller deals in both the United States and Europe as issuers took advantage of investor demand for yield.

DEAL STRUCTURE AND PROCESS

Leveraged finance transactions can generally be categorized as either committed financings or best efforts financings.

Committed Financings

In a committed financing, financial institutions commit to provide the desired financing on agreed terms and subject to customary conditions. In most cases, the borrower or issuer agrees to the basic terms, including pricing and covenants, in advance subject to certain specific changes to the extent necessary for the financial institutions to successfully syndicate or market the debt.

For high-yield bonds, in lieu of providing a forward underwriting of securities, the financial institutions typically provide a committed bridge facility, which would only be drawn if the high-yield bonds cannot be successfully placed in the market.

Committed financings are typically used in M&A transactions where the borrower/issuer needs certainty of funding prior to entering into a transaction that is not conditioned upon obtaining financing. The borrower or issuer will commonly enter into a commitment letter with the banks or other financial institutions providing the financing. The commitment letter includes detailed term sheets describing the key terms of the financing. The arrangers of the financing take the risk of being able to syndicate or market the financing, but are compensated through the payment of commitment or arrangement fees on the amount of the committed financing. Depending upon the complexity of the transaction, the size of the debt facilities, and the details included in the term sheet, the timeline for negotiating and executing the commitment letter could extend for several weeks. The time period between the signing of the commitment letter and the closing of the transaction is driven by the timing of the underlying acquisition or other transaction and can range from four or six weeks to longer than one year.

Best Efforts Financings

In contrast to a committed financing, most refinancing transactions involving leveraged loans and high-yield bonds are done on a best-efforts basis. This means that the financial institutions that arrange the financing will enter into an agreement with the borrower or issuer to syndicate or market the financing, but do not commit to provide the financing on any specific terms. The successful outcome of the financing will depend on the willingness of the market to participate, and the financial institutions do not risk their own capital if the financing cannot be placed in the market. Commensurate with this structure, the financial institution will not earn any fees if the financing does not close. The timeline for these transactions tends to be shorter as the commitment letter is replaced with an engagement letter that is typically less detailed, and the time between signing the engagement letter and closing of the transaction can be as short as one or two weeks.

DEAL TERMS

In 2017, many borrower and issuer-friendly terms continued to become more prevalent in leveraged finance transactions.

Leveraged Loans

Within the leveraged loan market, terms related to incremental facilities continued to evolve in a borrower-favorable direction. Incremental facility provisions permit a borrower to incur additional debt in the future, either in the form of additional term loans under a credit agreement or in the form of other indebtedness. The most common formulation permits a borrower to incur a fixed-dollar amount of additional debt, and then higher amounts depending upon a financial ratio. Many 2017 leveraged loan deals provided borrowers greater flexibility through growing fixed dollar baskets and variations of the ratio based components designed to provide more capacity. For example, a number of recent credit agreements permit incremental debt to be incurred not based on absolute leverage levels but on a requirement that leverage not be worse than prior to the incurrence if used to fund acquisitions or other investments. They may also permit the borrower to reclassify debt incurred under a fixed-dollar basket to be deemed incurred under a ratio basket if the borrower's leverage profile improves. In addition, various provisions permit borrowers to combine baskets in order to provide additional debt capacity. The most-favored-nation pricing protections, which can limit the ability to price future debt with higher interest rate spreads, also continued to weaken, with exceptions increasingly made based on time elapsed since the original deal, amount, type of incurrence (i.e., fixed dollar or ratio), currency, and financing sources.

Another area of focus for borrowers relates to mandatory prepayment provisions in credit agreements. Borrowers commonly obtained exceptions to the "soft call" repricing protections (which require a fee, usually 1%, to be paid in connection with any repricing transaction) for initial public offerings, certain other transformative transactions, and certain types of triggering debt. These provisions, which historically applied for up to 12 months after a deal closes, are now much more frequently applied only for six months. Other common exceptions to mandatory prepayment provisions included step-down thresholds for asset sales and de minimis exceptions for excess cash flow prepayments as well as other exclusions or deductions from the excess cash flow prepayment requirement.

In addition, in 2017 there were further exceptions to investment and restricted payment covenants as well as additional flexibility with respect to financial covenants. In sponsor-backed leveraged loan transactions, the norm continued to be springing financial covenants, which are tested only when amounts borrowed under a revolving facility exceed a certain threshold. These covenants increasingly provide cushion levels such that a decrease in EBITDA of less than 30-35% would not breach the covenant. In contrast, step-downs, which tighten financial covenants over time, have become less common. As a result of this and the changes in the regulatory landscape discussed above, financial covenant leverage levels continue to be set higher.

High-Yield Bonds

There have been fewer market changes in the high-yield market in 2017, due primarily to the slower high-yield bond market as compared to the leveraged loan market. As with 2016, the market trends in 2017 continued to be focused on increased flexibility with respect to covenant suspension provisions and dilution of the change of control protections for bond holders. There has also been further flexibility with respect to future debt incurrence, restricted payments, and mandatory prepayments in response to some of the changes in the leveraged loan market described above. The terms of high-yield bonds and leverage loans continue to converge.

LEGAL AND REGULATORY TRENDS

In 2017, there were legal and regulatory developments affecting both the loan and bond markets.

Leveraged Loans

Whereas in 2016 market participants' understanding of the Guidance was still evolving, in 2017—five years after the Guidance was first issued—market participants had gained a comfortable understanding as to how they must behave and structure deals under the Guidance. However, just as the market began to fully understand how the Guidance would be implemented, the enforceability of the Guidance was called into question. The Guidance was aimed at preventing future losses of the sort faced by many banks in the wake of the 2007 economic downturn. Losses by lenders at that time were exacerbated by risky, over-levered lending practices, with financings routinely provided at debt to EBITDA ratios of 7:1, 8:1, or even greater. Viewed by regulators as a systemic issue worsening the recession that occurred in the latter half of the 2000s, the Federal Reserve, FDIC, and OCC collectively issued the Guidance in an effort to cap the amount of risk that lenders are permitted to absorb.

In the years following the issuance of the Guidance, lenders faced uncertainty regarding its implementation. This uncertainty chilled the financing activity of some lenders who then faced a disadvantage in the market compared to those who interpreted the Guidance less conservatively. Recognizing the need to tighten up the market's understanding of the Guidance, the Federal Reserve, FDIC, and OCC provided further clarity in two steps. First, the regulators issued a November 2014 Frequently Asked Questions publication (FAQ memo), and second, the regulators participated in a February 2015 conference call (the red flags conference call) sharing what they determined to be red flags in leveraged lending. These red flags included debt to EBITDA ratios in excess of 6:1, overly optimistic cash flow projections, large percentage EBITDA adjustments, and other EBITDA adjustments lacking third-party diligence. In addition, during this same period, the regulators began to enforce the Guidance through monetary penalties and other sanctions.

As discussed above, in October of 2017, the GAO issued an opinion declaring that (i) the Guidance is a general statement of policy and therefore considered a rule for purposes of the CRA and (ii) as such, the Guidance is subject to the purview of Congressional review. The GAO opinion calls the current enforceability of the Guidance into question—since the Guidance did not undergo the required 60-day review, it may not be enforceable as a legal matter. Further, Congress is permitted to disapprove of a rule during the 60-day review period, which would render the Guidance null and void. As of the end of 2017, the impact of the GAO opinion remained unclear, with many market participants taking a wait-and-see approach. However, in the early part of 2018 the uncertainty surrounding the enforceability of the Guidance has been abated and it appears to be unenforceable, as discussed below.

Outside of the United States, the European Central Bank (the ECB) released its final guidance on leveraged transactions (the ECB Guidance) which took effect on November 16, 2017, and largely mirrored the Guidance. The ECB Guidance focuses on many of the same factors as the Guidance, FAQ memo, and the red flags conference call, with particular focus on a debt to EBITDA ratio of 6:1 or more, though other qualitative factors from the Guidance are repeated as well. The impact the ECB Guidance in Europe should be less dramatic than what was experienced in the United States. For one, it is unclear how effectively the ECB guidance will be enforced, with some European countries (e.g., the United Kingdom) not subject to the ECB. Even if the route to enforcement were clearer, more prominent European banks are already shying away from the types of all-time high-leverage ratios experienced in the United States during the financial boom, so many institutions are likely already in compliance with much of the ECB Guidance.

High-Yield Bonds

An important development in the bond market in 2017 concerned the effects of certain provisions of the TCJA, particularly on highly levered companies. The TCJA lowered U.S. corporate tax rates from 35% to 21% and permitted companies to fully write off capital expenditures in the year spent for at least the next five years. However, the TCJA also set forth a limit on the amount of interest expense that companies may deduct, which is now set at 30% of EBITDA, and beginning in 2022 will be 30% of earnings before interest, taxes and depreciation (EBIT).

While most high-yield companies will benefit from a drop in the corporate tax rate, certain highly leveraged and lower-rated companies will likely experience the negative effects of the decreased interest deductibility immediately. The number of high-yield companies that will be unable to fully deduct their interest expense, and the overall effect this will have on the financial performance of these companies, remains to be seen. If lower-rated, high-yield companies do perform poorly as a result of the TCJA while higher-rated, high-yield companies perform better as a result of the TCJA, there could be a stratification within the high-yield market with investors keeping their exposure to more highly rated, high-yield bonds and moving away from lower-rated, high-yield bonds.

MARKET OUTLOOK

Leveraged loan issuances weakened in the first quarter of 2018, down 33% year over year with a total volume of $167 billion. Technology continues to be the top industry for the sector, with financial services and general manufacturing rounding out the top three hottest industries for leveraged finance. Consistent with 2017, refinancing activity remains the main driver of loan volume in the first quarter of 2018, with new money representing only 32% of volume. Demand continues to outpace supply which has led to an environment in which borrowers flock to the market for better terms and pricing. Leveraged M&A lending volume is up by 9% when compared to the first quarter of 2017, driven by $43 billion in non-LBO issuance. Many market participants believe the M&A pipeline is strong heading into the second half of 2018, and this may sustain high levels of leveraged loans and high-yield bonds.

Default activity rose in March of 2018, led by iHeartCommunications' $6.3 billion default.

As of March 2018, high-yield volume is at $60 billion for the year, which is $28 billion less than the first quarter of 2017. However, the market conditions that drove the solid year for high-yield in 2017 seem to still be in place heading into 2018, including investor demand for yield and slow and steady federal funds target rate increases. In addition, as stated above, many believe the M&A pipeline is strong, which may provide opportunities for increases in high-yield bond offerings into the second and third quarters of 2018.

Current trends are expected to continue for the remainder of 2018, although the possibility of a shift in the benign economic environment is ever-present. Factors that are expected to impact the leveraged lending market in 2018 include the following:

- It is expected that demand for leveraged loans will continue to grow, driven by CLOs and other loan mutual funds as it was in 2017 and also driven by an increase in M&A activity. As of March, investors continued to pour into the leveraged loan market. A steadily rising base rate (LIBOR is up 62 bps since the start of the year) and the expectation that the Federal Reserve will continue to raise rates in 2018 drew an increasing amount of cash into the floating rate environment.
- In February, Joseph Otting, Comptroller of Currency and chief of the OCC, said banks can “do what they want” in leveraged lending as long as it does not impair safety and soundness, dealing what many consider to be a final blow to the enforceability of the Guidance. This statement seems to be in line with a Trump administration that has largely taken a lax view towards regulation. Against this backdrop, leverage ratios have surged to record levels in the U.S. loan market in the first quarter of 2018. This seems to pave the way for a higher number of LBO transactions with higher-leverage levels.

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