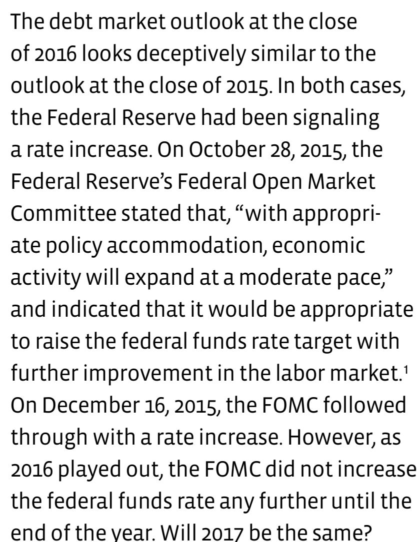
Two Skadden attorneys reveal what lenders should look out for in 2017.

By Seth Jacobson and Darrin Halcomb

Debt Market Outlook for 2017



The debt market outlook at the close of 2016 looks deceptively similar to the outlook at the close of 2015. In both cases, the Federal Reserve had been signaling a rate increase. On October 28, 2015, the Federal Reserve's Federal Open Market Committee stated that, "with appropriate policy accommodation, economic activity will expand at a moderate pace," and indicated that it would be appropriate to raise the federal funds rate target with further improvement in the labor market.[1] On December 16, 2015, the FOMC followed through with a rate increase. However, as 2016 played out, the FOMC did not increase the federal funds rate any further until the end of the year. Will 2017 be the same?

Before analyzing the interest rate outlook for 2017, it is helpful to examine the factors that caused the Federal Reserve to pause its policy of gradually increasing target interest rates in 2016. At the end of 2015 and in early 2016, real GDP growth was slow, with a real GDP growth rate below 1.0% for both the fourth quarter of 2015 and the first quarter of 2016. At the same time as the economy was experiencing slow growth, the unemployment rate was holding fairly steady through most of 2016. Slow growth, low but stable, unemployment, and falling energy prices were key factors in keeping inflation well below 2.0% throughout 2016. So, as 2016 comes to an end, we see there were many macroeconomic forces resulting in little pressure on the Federal Reserve to raise target interest rates.

Similar to a year ago, at its November 2, 2016 meeting, the FOMC said that, "with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace."[2] That sounds familiar, and, in fact, the FOMC announced an increase in the federal funds rate target at the final FOMC meeting of 2016 and stated that economic conditions are expected to evolve in a manner that will warrant gradual increases in the federal funds rate.[3]

While the end-of-the-year yield curves on U.S. Treasuries might lead to the conclusion that the outlook for 2017 is similar to 2016, important macroeconomic data suggest otherwise. Given real GDP growth in excess of 3.0% for the third quarter of 2016 and an unemployment rate at its lowest level in over nine years, markets are anticipating further federal funds rate increases in 2017.

The trend in credit spreads is also different as 2016 draws to a close. High-yield and investment-grade corporate bond spreads rose steadily during 2015 and by early 2016 were at levels just short of their post-recession peaks.[4] However, beginning in mid-February 2016, those spreads retreated and are now not far from their post-recession lows. Investors looking for higher-yielding opportunities and their willingness to accept more risk have reenergized the second-lien market, with second-lien loan issuance in November 2016 at its highest level in over two years, according to data from Bloomberg.[5]

The debt markets in 2017 are also expected to be affected by collateralized loan obligation issuance and inflows into leveraged loan funds. A robust rate of CLO issuance and large net inflows into loan funds should increase the supply of capital available to invest in debt markets. This increase in available capital may continue to compress spreads and create a favorable environment for issuers. The last few months of 2016 have been marked by significant loan fund inflows and CLO issuance activity. According to Lipper fund data as reported by LCD,[6] leveraged loan fund inflows in late November hit the highest weekly levels in over 3 years.[7] This increase in late November inflows combined with net inflows in most weeks during the second half of the year had the effect of offsetting net outflows during the first half of 2016. U.S. CLO issuance in the last few months of 2016 has also been strong, according to LCD, with September through November posting increases over the corresponding 2015 issuance numbers, though this only partially serves to offset the anemic CLO issuance activity from early 2016.[8] December's CLO issuance level will also likely be strong, but some of this issuance activity might be a result of issuers accelerating their timing to get in before the Dodd-Frank risk retention rules for CLOs go into effect on Decem-

ber 24, 2016.

Repricing and amend-to-extend activity was significant in the latter part of 2016, according to LCD data.[9] The increase in this activity may be due to a number of factors, but likely reasons include the increase in the supply of available capital, low credit spreads and the expectation that rates will rise in 2017. Refinancings in general have increased in 2016 as compared to 2015, particularly on the institutional side, with amend-to-extend activity surging in September. There was little repricing activity in the second half of 2015 and the first few months of 2016. In contrast, repricing activity was particularly strong in September and October of 2016.

Is the increased liquidity and investor demand for loan issuances a sign that bankruptcy and restructuring activity will remain muted in 2017? At the beginning of 2016, analysts and experts expected restructuring activity to increase in 2016 due to a combination of interest rate increases and sliding oil prices throughout the second half of 2015. Oil and gas restructurings (particularly by exploration and production companies) did dominate the headlines in 2016. There were also several high-profile bankruptcy filings in the retail sector, and the healthcare sector remains under stress and uncertain as to the effects of the change in the political climate. However, contrary to expectations early in the year, Chapter 11 filings remained flat in 2016 in spite of increased activity in the first half of the year, according to data from Epiq Systems as published by the American Bankruptcy Institute.[10] With strong loan market conditions in the second half of the year allowing issuers to extend maturities and lower interest expense, and with the small amount of outstanding loans maturing in 2017 and 2018 compared ($42 billion combined, compared to roughly $461 billion in the three subsequent years combined, according to LCD), many issuers that may have been under pressure due to the high cost of debt service and looming maturities have been able to relieve that pressure through amend-and-extend and repricing transactions and are therefore in a better position to weather the expected interest rate environment in 2017.[11] On the other hand, if interest rates rise as expected in 2017, and given the uncertainties in Europe and elsewhere, continued pressure on oil prices and sector-specific troubles, bankruptcy and restructuring activity may increase in 2017 despite the wave of amend-and-extend and repricing transactions.

Will the results of the U.S. presidential election have an effect on debt markets in 2017? Attorneys from Skadden Arps recently analyzed the potential changes in the U.S. legal and regulatory environment under a Trump administration.[12] The prospects for business tax reform, given the combination of a Trump administration and Republican control of Congress, has greatly increased. Tax reform could drive increased M&A activity, and the resulting need for debt financing, by U.S. issuers if such reform leads to lower marginal tax rates or provides for less expensive repatriation of foreign income. Lower marginal tax rates could have an impact on valuations of U.S. issuers and make them more competitive with foreign companies in M&A transactions, and a tax holiday on repatriation of foreign income or reduction in the tax rate on foreign earnings could free up cash to use for acquisitions in the U.S. With respect to cross-border transactions, the possibility of relaxed regulatory oversight under a Trump administration could lead non-U.S. companies to make increased investments in the U.S. and access the U.S. capital markets for such purpose. To the extent the Trump administration adopts a deregulation agenda, there may be additional sector-specific growth opportunities, such as in the energy sector, banking and insurance. But some of those opportunities may be offset in other sectors if the new administration places additional scrutiny on investments by foreign companies that raise national security risks or if it implements new trade policies that spur a reaction by some of the U.S.'s global trading partners.

Deregulation in the banking sector may also have an effect on the supply of credit. President-elect Trump has called for the elimination or substantial reduction of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and he has said that he supports proposals that would take power away from the Federal Reserve. But it is not clear that any change in the regulatory environment will result in a loosening of bank underwriting policies. Even if lending standards by regulated banks do not change, non-bank lenders have increased market share over the last couple of years and are poised to remain as a substantial influence in the debt markets, particularly in the middle market.

The strong loan market conditions in late 2016 and steady supply of credit (including by those non-bank lenders) have resulted in a borrower-friendly environment, not just in the case of pricing, but also when it comes to other loan terms and documentation. At the Loan Syndication and Trading Association's annual conference at the beginning of November, panelists cited EBITDA adjustments for anticipated cost savings or synergies and allowing borrowers to reclassify debt and liens after they are incurred in order to create more capacity in their capped negative covenant baskets.[13] The panelists also noted how these types of borrower-friendly provisions have been making their way into the middle market, as sponsors and counsel familiar with such provisions apply them to their middle-market transactions.

The asset-based lending market is no stranger to the phenomenon of borrower-friendly loan terms, as a glance at publicly available asset-based loan agreements entered into in 2016 demonstrates. The asset-based loan market has followed the institutional term loan market in permitting some borrowers to mirror some, but not all, of the terms of their high-yield bond indentures. Other borrower-favorable terms featured in multiple publicly available asset-based loan agreements

entered into in 2016 include: (1) the ability to include unrestricted cash (subject to a cap) in the borrowing base, (2) the ability to increase commitments up to the amount of the borrowing base if there is suppressed availability (and if there are lenders willing to provide such increased commitments), (3) permitting incremental commitments to be in the form of a "last-out" tranche and (4) allowing a portion of suppressed availability to be taken into account in determining whether certain availability conditions have been triggered. Other heavily negotiated provisions of asset-based loan agreements center around the definition of the borrowing base, eligibility criteria and on the agent's discretion to impose reserves. While borrowers have been able to negotiate some limitations on reserves, agents in asset-based loan transactions by and large retain some level of discretion over eligibility standards and reserves to protect their secured status.

New to loan documentation in 2016 was the presence of EU "bail-in" acknowledgment language, which by the end of the year had become very standard based on the LSTA's model language. Also growing in prevalence during 2016 was the ability for borrowers to borrow incremental loans or utilize new or existing commitments, subject to the satisfaction of certain limited conditions when such loans or commitments are being used to finance an acquisition or other "limited condition transaction." Two events occurred in 2016 that may precipitate loan documentation changes in 2017. First, the new accounting guidance for leases was finalized on February 25, 2016. The changes in lease accounting have been in the works for quite a while, and many loan agreements deal with the anticipated changes by freezing the current GAAP treatment of leases for purposes of financial calculations. As discussed in an LSTA webinar at the beginning of December, it is hoped that the finalized changes will not affect the calculation of financial ratios or covenant levels in most current loan agreements, but the exact wording will need to be reviewed, and drafters of loan agreements going forward should consider conforming the terminology used in such loan agreements to the new standard.[14] Second, with the Brexit vote over the summer, drafters of loan agreements should review the use of references to the EU and consider whether a separate reference to the UK is appropriate.

The views expressed in this article are not necessarily the views of Skadden Arps or any one or more of its clients. **TSL**

Seth Jacobson is a partner and global co-head of Skadden's Banking Group and practices in the Chicago office. He represents lenders and borrowers in connection with various types of sophisticated financing transactions in a wide variety of industries. Typical transactions include acquisition financings, leveraged loans, asset-based loans, complex intercreditor arrangements and leasing arrangements.

Darrin Halcomb is a counsel in Skadden's Banking Group and practices in the Chicago office. He represents borrowers, lenders, issuers and underwriters in connection with various types of complex financing transactions, including acquisition financings, asset-based loan facilities, leveraged loans, dividend recaps, cross-border secured credit facilities, secured note facilities, project financings, restructurings and workouts, debtor-in-possession financings and exit financings. Prior to joining Skadden, Mr. Halcomb worked in the economic research and public affairs departments at the Federal Reserve Bank of Chicago.

[1] FOMC press release, October 28, 2015.

[2] FOMC press release, November 2, 2016.

[3] FOMC press release, December 14, 2016

[4] BofA Merrill Lynch US High Yield Option-Adjusted Spread© and BofA Merrill Lynch US Corporate Master Option-Adjusted Spread© data retrieved from FRED, Federal Reserve Bank of St. Louis.

[5] Bloomberg Briefs: Leveraged Capital & Distress, November 8, 2016.

[6] LCD (Leveraged Commentary & Data) is an offering of S&P Global Market Intelligence.

[7] "Loan fund inflows surged to three-year high of $1.12B last week," November 28, 2016, http://www.lcdcomps.com/lcd/n/article.html?rid=161&aid=12407618.

[8] "Leveraged loans gain 0.26% in November; YTD return is 8.90%," December 1, 2016, http://www.lcdcomps.com/lcd/n/article.html?rid=161&aid=12407823.

[9] "A-to-E and covenant-relief activity decline in November," December 2, 2016, http://www.lcdcomps.com/lcd/n/article.html?rid=161&aid=12407975.

[10] http://www.abi.org/newsroom/bankruptcy-statistics.

[11] "A-to-E and covenant-relief activity decline in November," December 2, 2016, http://www.lcdcomps.com/lcd/n/article.html?rid=161&aid=12407975.

[12] "Looking Ahead: The U.S. Legal and Regulatory Environment Under a Trump Administration," November 14, 2016, https://www.skadden.com/insights/looking-ahead-us-legal-and-regulatory-environment-under-trump-administration.

[13] "Terms and Trends in the Primary Market," November 3, 2016, LSTA 21st Annual Conference.

[14] LSTA Week in Review, December 2, 2016.