Loan Market Shows Signs of Rebound Following Volatile End of Year

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After the 2018 fourth quarter roller coaster ride, when borrowers were essentially shut out of the leveraged loan market, the start to the new year has been tentative. Despite improved market conditions, leveraged loan volume for January 2019 was down 63% ($24.3 billion) from the previous year, according to the Loan Pricing Corporation (LPC) — the lowest issuance volume since 2012. The instabilities in the geopolitical landscape and economic markets that caused the bumpy fourth quarter of 2018 resulted in more risk-adverse behavior in the loan markets, which in turn contributed to a slow start to the year.

Notwithstanding the cautious beginning to the year, the market has shown signs of a rebound. Leveraged loan issuances in February 2019 spiked in volume from January 2019, with LPC data reporting $61.2 billion of loans being issued and $29.3 billion of new money loan issuances (as compared to only $9.9 billion in January 2019). However, this still lags far behind the $114.4 billion of leveraged loans issued in February 2018. March 2019 showed a small decline in new issuance volume, with $21.5 billion of loans, but remained generally in line with the February 2019 numbers, according to LPC.

As a result of the "risk off" mode from investors and the backlash from the fourth quarter of 2018, lower-rated borrowers with more challenging technicals continue to have less traction in accessing the loan market; instead, companies braving the market in the aftermath of the fourth quarter tend to be well-regarded borrowers with favorable credit stories and industries, and those companies have contributed to the majority of the new issuance activity in the first quarter of 2019. This shows a marked difference from the third quarter of 2018, when lower-rated borrowers represented a greater percentage of loan issuance volume. According to data from Leveraged Commentary & Data (LCD), issuers rated B+ or lower accounted for only about half of all U.S. leveraged loan issuance over the past six months, a sharp decrease when compared to the 68% share for such issuers in the third quarter of 2018. In addition, due to higher interest rate margins, refinancing and repricing activity remained very low in the first quarter, accounting for just 3.5% of loan volume, compared to 64% during the same period last year, according to Debtwire.

Similarly, borrowers incurring incremental term loan B debt in the first quarter found they had to increase interest margins in their existing loans and, in some cases, such incremental debt triggered "most favored nation" (MFN) provisions under their credit agreements. MFN provisions typically apply when borrowers incur incremental term loan debt with an effective yield (interest margin plus any original issue discount) that exceeds the effective yield on its existing term loan by more than an agreed-upon threshold (customarily 50 basis points, or bps). When this happens, the interest margin and/or original issue discount on the existing term loan increases by the amount that exceeds the threshold. Based on data from LCD, 38 add-on loans were launched in the first quarter (through March 18, 2019). Of those, 12 (32%) were nonfungible and priced with interest margins that were 80 bps higher on average than the existing loan. The remaining 26 were fungible add-ons; of those, eight (31%) resulted in an upward repricing of the existing loan by an average of 44 bps.

As a result of the negative implications on interest margins (including with respect to MFN being triggered on existing loans), borrowers are shying away from term loan issuances. High-yield bonds (including secured bonds) are instead gaining popularity, with companies opting to issue bonds to repay term loan debt. According to LCD, through March 14, 2019, completed bond-for-loan offerings totaled $11.9 billion and accounted for 26% of the nearly $50 billion of year-to-date volume, which represented the highest

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percentage since the fourth quarter of 2016. In addition, with respect to the financing of corporate mergers and acquisitions, more high-yield bonds are being issued than leveraged loans for the first time since the third quarter of 2015. As of March 31, 2019, high-yield notes constituted 61% of the aggregate leveraged finance debt outstanding, while first-lien institutional loans only comprised 37%, according to LCD. With the Federal Reserve indicating that it does not intend to further raise interest rates in the near future, the bond-for-loan trend is expected to continue as issuers have less incentive to choose floating rating loans. This preference for bonds may further depress the leveraged loan market.

On the upside, the relatively low volume of new issuances has resulted in more borrower-friendly pricing. Based on LCD data, 16 of the 30 loans allocated in February 2019 included tightened pricing in terms of interest and/or original issue discount during syndication, while only five flexed wider (i.e., increased prices). Similarly, 14 of the 29 loans allocated in March 2019 had decreased pricing during syndication, while four flexed wider and the remainder stayed at their original levels, according to LCD. This shows a marked improvement from December 2018, when 19 out of 25 deals flexed upward and no loans priced downward. Additionally, the secondary loan market also reflects the improving conditions for loan issuances. According to LPC, in February 2019, 63 percent of loans had an average bid in the 98-to-par range, which represents an increase from 50 percent in January 2019 and 22 percent in December 2018. This means that loans in the secondary market are increasingly being sold at or close to their face value (*i.e.*, par) instead of being discounted.

Although deal terms remain more protective of lenders than those in play as recently as the third quarter of 2018, solidifying market conditions have resulted in some loosening of deal terms, in particular around MFN sunsets and carve-outs, incremental facility baskets and EBITDA (earnings before interest, taxes, depreciation and amortization) adjustment caps. In contrast to December 2018, when MFN carve-outs and sunsets as well as uncapped EBITDA adjustments were flexed out across the board during syndication, some recovery with respect to these terms was evident in the first quarter of 2019, in particular for stronger credit borrowers and larger sponsors. At the same time, term B loans continued to be predominantly covenant-lite (*i.e.*, not subject to any financial maintenance covenants).

The outlook for the second quarter of 2019 remains optimistic, as calming loan conditions point toward the possibility of more opportunistic deals, M&A activity and further improvements in terms and pricing for borrowers — in which case more new money issuances, refinancing and repricing activity, and incremental facilities can be expected. However, it is unlikely that the loan market this year will be as robust as it was before the crisis in the fourth quarter of 2018. The volume of issuances will likely be lumpy as factors such as high-yield bonds continue to take a greater share of leveraged lending, and geopolitical uncertainty and concerns around a slowing economy all contribute to less visibility for the loan markets.