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EVALUATING THE HEALTH OF LOAN AND BOND MARKETS FOR 2016

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Corporate borrowers and issuers typically access the credit markets only for need or opportunity, so may not actively monitor loan market conditions. As a leading firm with a nationally ranked practice representing borrowers and issuers in credit transactions, Smith Anderson is positioned to view the credit markets with those perspectives in mind. Our clients often find it helpful for us to share impressions and updates on the loan and bond markets, and below are a few thoughts on the credit markets as we look back to 2015 and forward to developments for this year.

2015 Market Review

Lending Down Overall

Although aggregate activity in the loan markets was robust by historical standards for 2015, overall lending was down:

- U.S. syndicated loan issuance was 6 percent less than 2014, a reflection of decreased leveraged loan issuance (down 17 percent) partially offset by a 4 percent increase in investment grade lending.
- For the large cap leveraged segment of the market, institutional (non-bank) lending was down by 36 percent while banks actually increased their lending by 1 percent.
- Refinancings were down by a significant 31 percent margin, while new money loans – primarily driven by M&A – were up by 3 percent to a record $546 billion.

Despite the overall decline in lending, attractive covenants remained the order of the day, with 75 percent of credit agreements for large cap borrowers characterized as “covenant lite” – up from 68 percent the prior year.

Less Leverage Tolerance

As banks continued to move into compliance with new leveraged lending guidelines, they showed less tolerance of leverage, and non-bank lenders followed suit to a lesser degree. Overall, leverage levels for large corporate buyout deals tightened to about 5.6 (debt to EBITDA) in the fourth quarter of 2015, down from 6.2 times in the third quarter – the lowest levels seen since Q4 of 2011. Highly-leveraged large corporate LBO deals (7 times and higher) fell to 13 percent of all transactions in 2015, down from 26 percent in 2014 and well below the 39 percent level seen in 2007 prior to the financial crisis. The new peak in M&A financing was more strategic, less sponsor- and LBO-driven and less leveraged than in prior years.

Middle-Market Loans

Trends for middle market borrowers were similar to those for large cap borrowers in 2015, with the overall volume of lending down 30 percent to $142 billion, $34 billion of which was for the traditional smaller middle market. From quarter to quarter, loan volume varied significantly, as did interest rates, but by Q4, average all-in interest rates for middle market loans had risen to 7.14 percent per annum – the highest level since 2012. Direct lenders, representing pension funds and other aggregators of capital, continued to be potential competitors for middle market transactions, and in lieu of bank-led syndication, many loans were made in club deals led by sponsor-controlled lenders. As with the large cap market, M&A lending was the area of growth in 2015, and this appears likely to continue to remain the most active segment of the market for at least the first quarter of 2016. Transaction financial terms have been evolving to lessen risk, however, and for 76 percent of middle market LBOs in 2015 the equity requirements were in excess of 40 percent.

Increase in Loan Defaults

Volatility in 2015 was driven by factors external to the debt markets, of course, but also by the perception and reality of increased credit risk. The rate of loan defaults increased in 2015 after years of historic lows, such that 27 issuers defaulted on a total of $16.4 billion in principal amount. For 2016 the default rates on loans are anticipated to continue to grow, and Fitch Ratings has projected a 2016 U.S. institutional leveraged loan default rate of 2.5 percent, equating to $24 billion of defaults – a 50 percent increase in default volume over the trailing 12 months.[1] Higher levels of default are perceived as reflecting uncertainty and can affect the levels of funds available to the debt markets.

Availability of Funds

Other factors are also lessening the availability of credit. Outflows from loan funds have continued, and general outflows from retail loan funds (which fell by 19 percent in 2015) have brought those funds to their lowest levels since March 2013. Formation of collateralized loan obligation (CLO) funds – which began 2015 strongly and reached $427 billion in assets under management by December – also has slowed in recent months. As available loan funds diminish, the markets will need to address the large “overhang” of delayed loan transactions that were postponed late last year after the $3.3 billion Veritas transaction was pulled in November. The overall demand for loans and other debt by borrowers will be key, but at any level that demand will need to be satisfied by somewhat diminished pools of available funds.

Energy and Mining Sectors Strongly Impacted

No discussion of 2015 would be complete, of course, without a mention of the turbulence in the energy and mining sectors, which has rippled into the broader economy and the markets. Energy and mining companies had been particularly active in the high-yield bond market in recent years, so when Peabody, Arch Coal and other issuers in the industry appeared at risk for default, the secondary market prices for bond issues tumbled, falling from average bids of 101.45 to 87.84 in mid-December. The loan markets were more stable, as is typical, and are less exposed to coal, gas and other energy and mining companies, but were not immune to volatility. Average bids in the secondary market for loans throughout 2015 reflected a drop of 416 basis points (4.16 percent) in loan bid amounts while 16 percent of loans bid below 90 percent of par at the end of the year. Those trends have continued into 2016 with global uncertainty and volatility in the equity and bond markets such that the broader US secondary loan markets were bid down to 91.57 basis points by January 25 of this year. Secondary markets have a direct impact on the availability of credit in the primary loan markets, since low secondary market prices can draw loan investors who otherwise would devote their capital to the funding of primary loans.

Rise in Interest Rates
As one would expect in a time of volatility and tighter credit, average all-in interest rates on new large cap syndicated credit facilities (referred to as "yield" for the lenders) rose toward the end of 2015 from 5.39 percent per annum at the end of Q3 to 6.14 percent at the end of the year. These are not historically high yields by any means and do not reflect a level of uncertainty anywhere near that experienced in 2007, but borrowers nevertheless are facing higher interest costs.

Outlook for 2016

Key Takeaways for 2016
So, what are some of the takeaways for borrowers and issuers looking to 2016? One is that the possibilities for opportunistic refinancings in 2016 may be limited. This is a year when companies will complete financings for strategic reasons, but are not likely to see a wave of financings to reduce rates or improve other terms. If a borrower or issuer does need to engage the debt markets, then their timing may be critical. Headlines of defaults or bankruptcies could roil the markets at any time (as could other major economic news), and although the impacts of these disruptions will often be temporary, borrowers will need to be in a position to be patient.

The secondary markets for loans and bonds may also continue to have significant impacts, with lower secondary market prices creating opportunities for loan or bond investors, but at the same time draining capital from the primary markets for new loans and bond issuance. (Depending on the terms of their bond or loan documents, some issuers and borrowers also may find opportunities to benefit from precipitous drops in the pricing of their debt on the secondary markets by repurchasing and canceling a portion of that discounted debt.)

In a nutshell, if a borrower or issuer needs debt in 2016, they will want to ensure they have:

- Ample time to complete the proposed transaction;
- A clear strategic rationale;
- No immediate market disruption or the capacity to wait one out;
- No recent negative news on the borrower/issuer and an awareness of likely positive news/publicity;
- One or more banks highly motivated to establish a strong relationship;
- Clear objectives as to refinancing (which will drive considerations around negotiating for prepayment possibilities);
- The ability to absorb increased costs reflecting current credit terms; and
- Creative alternatives in mind for potential alternative lenders and bond investors.

With these pieces in place, borrowers and issuers can be confident that they have optimized their prospects for a successful financing in the coming year.

For further information on these topics, or to discuss other finance-related issues, please contact **Lee Kirby**, **Bart Norman**, **Armand Perry** or another member of the **Smith Anderson Debt Finance practice**.[2]

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[1] These default rates are not high by historical measures. According to the recent Fitch report, the overall high yield bond default rate ended 2015 at 3.4 percent, above Fitch Ratings' 2.2 percent historical nonrecessionary average, but below the 11.1 percent recessionary mark and the 4.1 percent overall average.

[2] Except as noted otherwise, Thomson Reuters LPC is the source for statistics and other data quoted in this article.

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