The U.S. Leveraged Loan Market
Today’s drivers, tomorrow’s challenges

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Presentation Overview

- Today’s Leveraged Loan Market
- Tomorrow’s Regulatory Environment
- What Might Happen When They Meet
Today’s Market
Setting the Stage: Federal Reserve buys assets… And investors seek yield (and assets) elsewhere

Federal Reserve Balance Sheet

Source: Federal Reserve
Money flows into loan mutual funds…and AUM Climbs

Loan Mutual Fund Monthly Flows

Loan Mutual Fund AUM

Source: Thomson Reuters LPC
CLO issuance climbs
(but CLO AUM not moving as much)

Monthly CLO issuance

CLO AUM

Source: Thomson Reuters LPC, Citi
Institutional outstandings climb past Pre-Crisis levels

Institutional Issuance vs. Outstandings

Source: S&P/LCD, S&P/LSTA Leveraged Loan Index
“Visible” demand outstrips supply by nearly $50 billion

Institutional Issuance vs. Outstandings

Source: S&P/LCD, S&P/LSTA Leveraged Loan Index

Amount ($Bills.)

Jan-12, Feb-12, Mar-12, Apr-12, May-12, Jun-12, Jul-12, Aug-12, Sep-12, Oct-12, Nov-12, Dec-12, Jan-13, Feb-13, Mar-13, Apr-13, May-13, Jun-13, Jul-13, Aug-13, Sep-13, Oct-13, Nov-13

Cumulative CLO/mutual fund demand
Cumulative change in outstandings

Source: S&P/LCD, S&P/LSTA Leveraged Loan Index
Impact on terms & conditions
There *are* more covenant lite institutional term loans

- Covenant lite loan issuance now comprises half of new issue institutional loans – and 40% of outstanding loans
- These loans do not have maintenance covenants, but *do* have incurrence covenants
- Covenant lite loans returned because they performed well: Lower default incidence and higher recovery given default in the crisis

*Source: S&P/LSTA Leveraged Loan Index*
New issue loans: Metrics are more bullish…but not at 2007 levels

- While debt/EBITDA multiples are climbing, coverage ratios are very strong

Source: S&P/LCD/Capital IQ
New issue loans: Institutional term loan spreads
Contracting, but well above pre-Crisis lows

BB/BB- rated institutional term loans

B+/B rated institutional term loans

Source: S&P/LCD/Capital IQ
The Regulatory Environment:
Risk retention & Leveraged Lending Guidance & Volcker, Oh My!
Risk Retention
CLOs are the biggest non-bank lender… If they are no longer viable, what happens?...

Investor Market Share in Primary Institutional Loan Market

Source: S&P/Capital IQ/LCD
Risk Retention Shutters CLOs: According to an LSTA survey, market shrinks by more than 75%

The LSTA asked managers running 70% of U.S. CLOs whether they could manage CLOs if they were required to retain 5% of the fair value of any new CLOs.

According to the LSTA Survey, managers, who currently manage more than 500 CLOs, said they would only run approximately 70 CLOs – in total – if the risk retention rules went into effect as originally written (left).

They estimated it would reduce the CLO market by 75% (right) …and this is before the disruptive horizontal retention cash flow diversion language.

Source: LSTA Manager Survey, July 2013
Without risk retention (yet), U.S. CLO formation has recovered; European CLO formation has collapsed

- U.S. CLO formation has recovered, bringing capital to U.S. companies
- European CLO formation collapsed, due in part to risk retention rules
Performance: CLO note impairments have been all but non-existent

Over the course of 17 years, the cumulative impairment rate of CLOs has been de minimus – less than 1.5% in that entire time span

Losses will be lower than impairments, because impairments can include market value EOD, distressed exchanges, etc., in addition to realized losses

Source: Moody’s Investors Service
Why should I care if the CLO market shrinks?

- **Scenario 1:** Other credit providers do not step in... leveraged loan market contracts... reducing availability of credit to non-IG borrowers (particularly in the middle market)

- **Scenario 2:** Other credit providers (such as HY bonds) do step in... but magnitude of replacement depends on elasticity of demand... margins increase... increasing the cost of credit to non-IG borrowers

- **Scenario 3:** Other credit providers (such as loan mutual funds) do step in... but this replaces match-funded investors with maturity transforming investors... possibly increasing the volatility of the loan asset class
Leveraged Lending Guidance
Leveraged Lending Guidance

- **Areas of explicit focus include (but are not limited to…)**
  - Defining leveraged loans – leverage, purpose, HLT definition, RE secured loans, etc
  - Underwriting standards – deleveraging ability, covenants
  - Pipeline management
  - Enterprise valuation
  - Reporting and analytics
  - Risk rating loans
  - Deal sponsors
  - Stress testing

- **Particular areas of focus (or so we hear…)**
  - Ability to amortize senior secured debt or 50% of all debt in 5-7 years
  - Covenant lite loans

- **Applies not just to loans held by banks, but also loans arranged (but not held) by banks**
  - Defining Concept (?): Banks should not underwrite loans they are not willing to hold
Institutional term loan pipeline being managed tightly

Institutional Loan Pipeline Below 2007 Levels...

Source: Thomson Reuters LPC
There definitely *are* more covenant lite institutional term loans

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Source: S&P/LSTA Leveraged Loan Index
In the 2013 SNC Review, Classified Assets decreased, but Criticized Assets increased. This was primarily driven by an increase in Special Mention loans. SNC Review referenced the Leveraged Lending Guidance…and observed that a “focused review of leveraged loans found material widespread weaknesses in underwriting practices, including excessive leverage, inability to amortize debt over a reasonable period, and a lack of meaningful financial covenants.” 42% of leveraged loans were criticized.

Source: 2013 SNC Review
How might Leveraged Lending Guidance impact the leveraged market?

- **Background:** The HLT designation from the early 1990s helped launch the institutional term loan market.

- **What is happening with the market today?**
  - Generally…mass confusion

- **What might ultimately happen?**...
  - Banks figure out how to comply; the market continues?
  - Banks back away from leveraged lending; the leveraged finance market shrinks?
  - Banks back away from leveraged lending; senior secured floating rate market develops?
  - Banks back away from leveraged lending; non-bank originators step in?
Ultimately, today’s leveraged loan market is simply responding to supply and demand cues…

…But longer term, regulation may drive the evolution (or devolution) of the leveraged loan market