Default Cycle Kept at Bay ……. for Now

By: Phil Van Winkle and Jon Morrison

We talk with capital providers, attorneys, investment bankers, private equity and other market participants every day and *everyone* sees it. Just like we all saw it in 2006/07 and in 1997/98. Capital becomes readily available due to monetary policy or other market forces and it *must* be put to work. No matter how much they may know better, investors of this capital need to do deals. In the competition to do deals – leverage rises, pricing falls, structures deteriorate and marginal borrowers receive financing. Guess what? It's happening again.

The question is no longer "Have we entered the danger zone?" We have. The real questions are: "When will the day of reckoning come?" and "What can we do while we wait?" Rampant capital availability and favorable covenant regimes can mask poor management and marginal businesses for a while, but inevitably the weight of excessive leverage or an exogenous shock to the capital markets will topple the marginal players.

Most observers believe that rising interest rates will be the straw that breaks the camel's back and this is probably true – that or an external shock. We don't disagree. We are also absolutely certain that underneath the refinancings and clean compliance reports a time bomb is ticking. Ownership, management and lenders would be well placed to look past the lack of current defaults and to undertake critical assessment, preparation and remediation now before a less favorable capital environment is upon us and the damage is irreparable.

A low default-rate environment is not synonymous with a healthy borrower environment. Underperformance continues unaddressed simply because the *discipline of debt* is not in place – only the debt itself. AEG Partners has recently been brought into two situations which were not facing imminent defaults, but where the Board, in one instance, and private equity ownership, in the other, saw that management and operations were not performing as expected. In each case, we were able to provide a road map to improvement and accountability (jump to more).

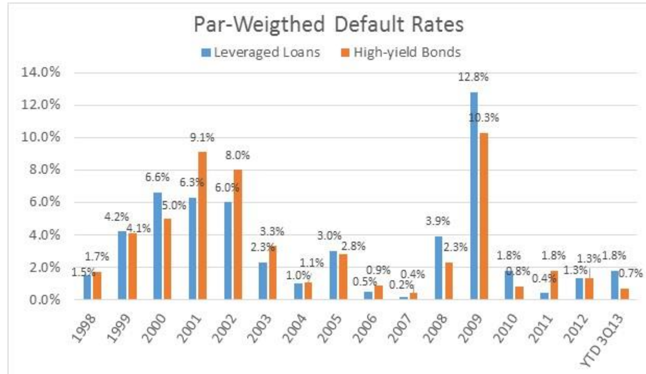
In the discussion below, we review the cases for and against a near-term rise in the default rate and give two recent examples of value-added "restructuring" work that can be done outside of a default scenario.

The Case for an Increase in Corporate Defaults

It seems that all players in the market agree that the capital markets have returned to, and possibly exceeded, the irrational exuberance that characterized the period leading into the last recession and default cycle in 2007. Today, leverage is at all-time highs, there is "too much money chasing too few deals", and credit standards and loan structures have deteriorated significantly. The Fed in its 2013 Shared National Credit Review notes that "forty-two percent of the leveraged loan portfolio was criticized by examiners. [Their] focused review of leveraged loans found material widespread weakness in underwriting practices, including excessive leverage, inability to amortize debt over a reasonable period and lack of meaningful financial covenants."[1] Below, we take a closer look at the factors suggesting that corporate defaults are poised to increase.

Long bull run for credit

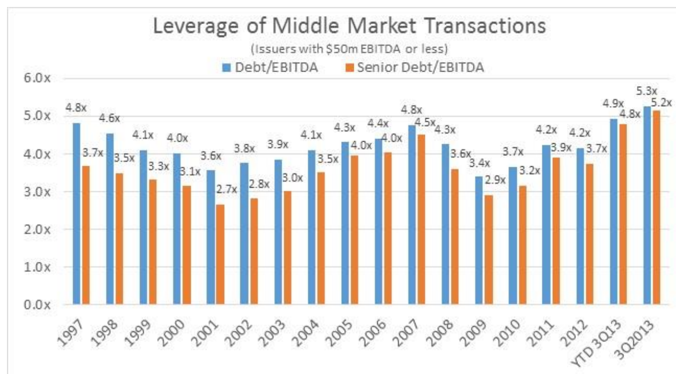
The default rate for middle market loans, large corporate loans and corporate bonds has been running below the long term average (approximately 3.5% for loans and 4.0% for bonds) since the middle of 2009. Further, default rates have been below their long-term averages for roughly nine of the past eleven years. The "reversion to the mean" theory argues that the market will not remain below its long-term average indefinitely. A reversion to historical average default rates would mean an increase of approximately \$25 billion of defaulted leveraged loans and approximately \$35 billion of high yield bonds.



Source: J.P. Morgan, *Leveraged Loan Market Monitor*, December 2, 2013

Leverage is as high, or higher, than at any point in the last sixteen years

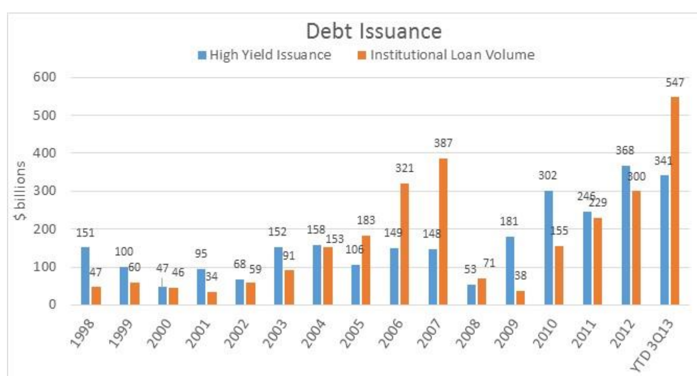
In the 3rd quarter of 2013, leverage on new middle market loans topped 5.2x. Through the third quarter of 2013, leverage on middle market transactions stood at 4.9x and will likely top 5.0x for the full year. Since 1997, leverage has never exceeded 4.8x for the full year and has averaged approximately 4.1x during that same period. Furthermore, middle market transaction leverage now exceeds large corporate leverage, reversing an almost twenty year trend. Leverage in the large corporate market stands a couple of ticks below the middle market for the first three quarters of 2013 at 4.7x.[2]



Source: S&P LCD, *Middle Market Lending Review*, 3Q 2013

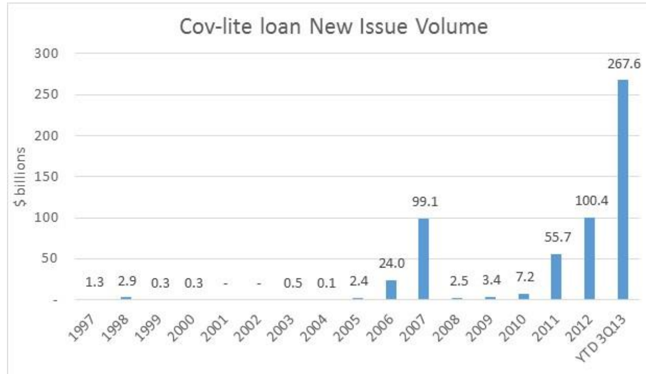
Large corporate loan volumes are up and structures are deteriorating

Large corporate leverage loan volume through the <u>first three quarters</u> of 2013 was \$547 billion, exceeding the previous <u>annual</u> high by 41%. Loan volume previously peaked in 2007 just prior to the spike in the default rate beginning in 2008.



Source: J.P. Morgan, *High Yield Default Monitor*, October 31, 2013

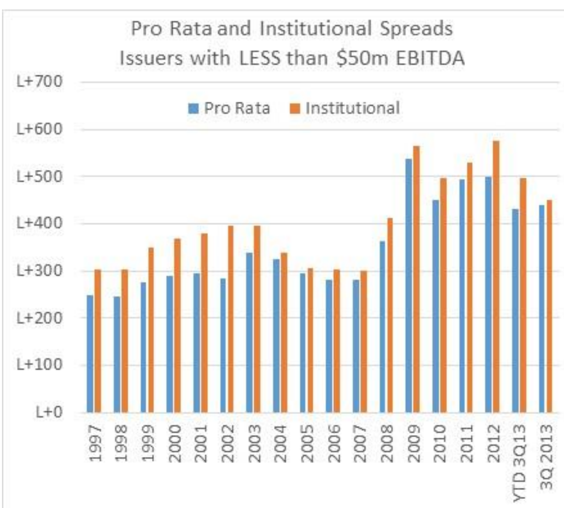
Evidence is also mounting that credit terms and structures are weak and deteriorating. Of the $547 billion of year-to-date loan volume, $267.6 billion or 49% has been covenant-lite. Furthermore, according to numerous market participants, the past two quarters have seen a material weakening of restrictive covenants including debt basket, dividend, and use of proceed clauses.

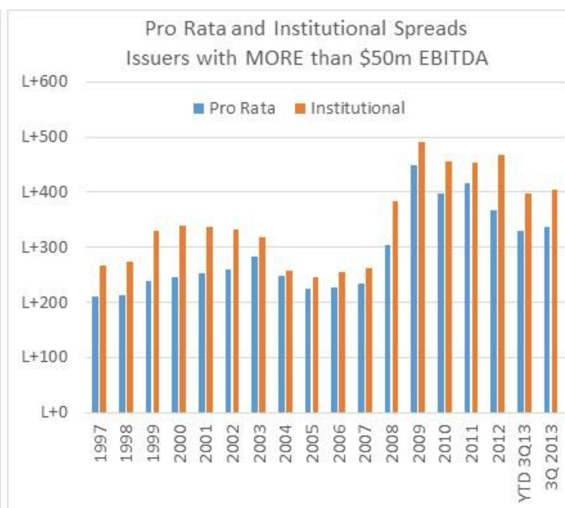


Source: J.P. Morgan, *High Yield Default Monitor*, October 31, 2013

Spreads are high

Both middle market and large corporate spreads remain at historically elevated levels. Spreads have not moved materially down from 2008-10 recession levels. Middle market spreads have averaged over 400bps since 2008 and are currently approximately 450bps. Spreads did not exceed 400bps for the entire period from 1997 thru 2007. There is also a historically high gap between middle market and large corporate loan spreads, indicating a heightened perception of risk in the middle market. The imputed default rate based upon current spread levels is approximately 3.5% - much closer to average historical default rates than the current 1.8% actual default rate.





Source: S&P LCD, *Middle Market Lending Review*, 3Q 2013

Interest rates have to increase . . . sometime

The elephant in the room remains interest rates, which continue at historically low levels due, primarily, to quantitative easing policy. Low interest rates keep debt service expenses low (even at relatively high leverage rates) but also reinforce the excess capital cycle as investors looking for yield flock to loan funds. The speed of QE tapering and the impact on rates is uncertain and widely open for debate, but everyone agrees that rates have nowhere to go but up.

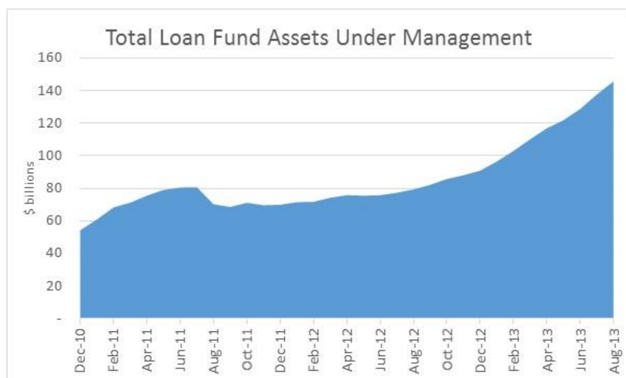
Source: Federal Reserve Bank

The Case Against a Near-Term Increase in Defaults

Despite all the credit trends that suggest the market is peaking and an increase in defaults is inevitable, the stronger argument still resides in the case *against* a significant near-term increase in the default rate. Factors including availability of capital, low interest and high coverage rates, and a reduced pool of outstanding middle market loans suggest that the string of below average default rate years will continue through 2014 and possibly well into 2015.

The market continues to be awash with liquidity

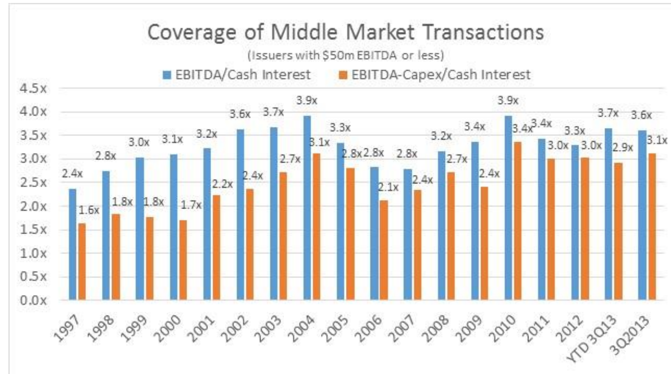
Fund flows into bank loan mutual funds and exchange traded funds remain robust with positive fund inflows for the past 76 weeks according to S&P LCD[3]. In the week ended November 27, 2013 alone, there were positive inflows of $823 million. During the 76 weeks of positive inflows a total of $57.7 billion has been invested. YTD 2013, has seen $50.3 billion of inflows and is on pace for a $70 billion year. CLO's also continue to print money with YTD volumes of over $75 billion and forecast for $50-$70 billion of new issuance in 2014. In aggregate, assets in bank loan mutual funds and ETFs are up 133% since year-end 2012.



Source: S&P LCD, *Leverage Lending Review*, 3Q 2013

All-in interest rates remain low keeping coverage high

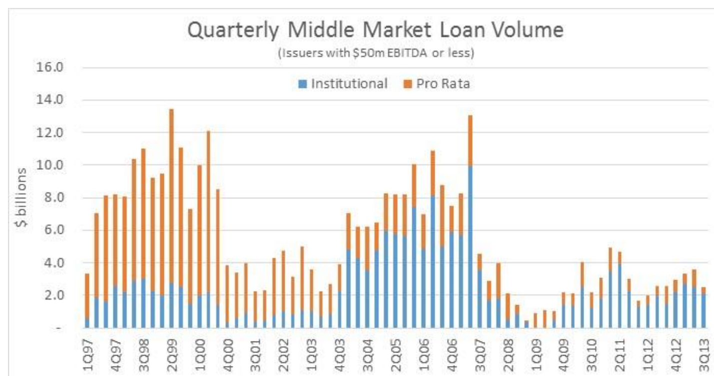
Even though spreads remain at relatively high levels and leverage is peaking, cash interest coverage remains very strong due primarily to low LIBOR rates. Six month LIBOR today is approximately 0.38% versus 4.8% and 2.2% in December of 2007 and 2008, respectively. The low cost of LIBOR means that even with high spreads and high leverage, senior debt interest coverage is as strong today as at any point in the past 15 years.



Source: S&P LCD, *Middle Market Lending Review*, 3Q 2013

Middle Market Loan Volumes Remain Soft

Since the 4th quarter of 2007, there have been 25 consecutive quarters below $5 billion of middle market loan volume. Volumes at this level were last seen in the period from Q4 2001 to Q1 2004 which saw 13 consecutive quarters of issuance below the $5 billion level. The story is similar for the number of deals done over this period. In contrast, 2004 through 2007 witnessed much higher volumes with several quarters topping $10 billion leading into last default cycle.

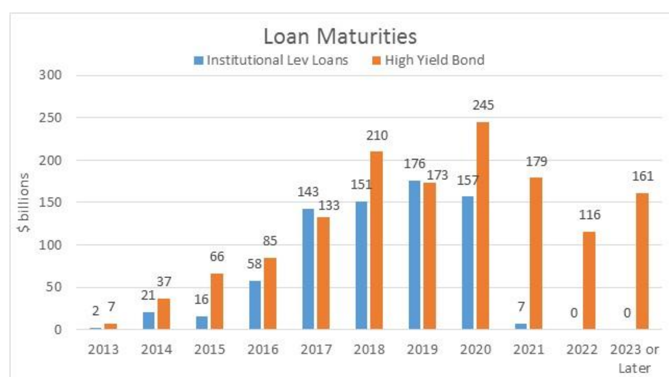


Source: S&P LCD, *Middle Market Lending Review*, 3Q 2013

The par amount of outstanding of middle market loans is currently approximately $9.2 billion the lowest level since 2004. Outstandings have declined in each of the past four years and in seven of the last eight years.

The "Maturity Wall" has been addressed

Coming into the 2007/08 cycle the "Maturity Wall" was one of the most often discussed factors about why the default rate would soar to all-time highs. As we know now, due initially to the "amend and pretend" phenomena and later to capital availability, the Wall was never much more than a bump. Similarly this time around, debt maturities are not likely to be a major story in the near-term. The "Maturity Wall" is very low and remains moderate into 2018. Issuers have worked down the pre-2016 maturity wall by approximately $650 billion with only $39 billion of institutional loans and $110 high yield bonds coming due in the prior to January 2016.



Source: J.P. Morgan, *Leveraged Loan Market Monitor*, December 2, 2013

Deteriorating loan structures and capital availability reduce chance of default

Regardless of corporate performance levels, the increase in covenant-lite deals over the past three years will delay defaults in many cases until a company misses an interest or principal payment or faces maturity. Further, loose restrictive covenants may also postpone the “day of reckoning” as companies enjoy flexibility and discretion to add debt or sell assets to avoid default.

One “positive” loan structure attribute relative to LBO’s that also works to help keep defaults at bay has been the amount of equity contribution required as a percent of total consideration. Since 2008, the equity component of middle market LBO transactions as exceeded 40%.[4] Interestingly, the equity component of large corporate deals has deteriorated from a peak of 46.5% in 2008 to only 29.5% in the third quarter of 2013.[5]

Preparedness in a Low-default Rate Market

A low default-rate environment is not synonymous with a healthy borrower environment. As discussed above, low interest rates and loose (or no) covenants simply allow management to operate free from the prying eyes of lenders and often also Boards or Ownership. As the cycle extends and more and more marginal businesses are being financed at ever-higher leverage ratios we know that there are strategic, operating, cash management and other issues that are going unaddressed simply because the *discipline of debt* is not in place – only the debt itself. These issues risk escalating from “addressable” to “catastrophic” if left to fester until the default finally arrives.

At AEG Partners, we have recently been brought into two situation which were not facing imminent defaults, but where the Board, in one instance, and private equity ownership, in the other, saw that management and operations were not performing as expected. In each case, we were able to provide a road map to improvement.

In the first instance, AEG was hired by the Board to develop a strategic plan in order to maximize the value of the Company. For the last several years the stock performance was flat and low. The Company was not facing an imminent default but the Board deemed it prudent to undertake a comprehensive review of the business and its prospects. AEG spent approximately six months performing a detailed review of the Company, developing critical recommendations, and providing management with a detailed roadmap for implementation and accountability. Specifically, AEG's detailed review of the Company's four main business lines resulted in a plan to keep and improve two of the businesses, evaluate the sale of a third business, and to immediately exit a fourth. For the "keep and improve" businesses, AEG constructed a detailed plan addressing issues from procurement, to the shop floor, to cash management and personnel. AEG also identified "champions" within the Business units to lead the implementation process. The Board took our recommendations to heart and began to immediately implement our recommendations. In the ensuing two quarters, the Company's stock price has nearly tripled.

In the second instance, AEG was hired as the Interim Chief Operating Officer of a large manufacturing, software and service company on the recommendation of the equity sponsor. The Company's performance had been sub-par for some time and the equity sponsor wanted to improve performance. As COO, AEG spent 30 days evaluating the operations and prospects of the Company and within 90 days developed a detailed plan for the rationalization of the production processes and facilities, labor force, and senior management team. AEG was also active in meeting with core customers of this business to reassure them that measures were being put in place to improve quality, on-time delivery and service of the Company's products. Working with key members of the equity sponsor's team, AEG is currently in the process of implementing the key findings and recommendations. Based upon the identified actions, the Company now expects to see significant EBITDA improvement in the short-run and even more dramatic improvement once all the changes are in place.

Conclusions

Almost all players in the leveraged loan market realize that leverage levels and loan structures have reached the danger zone where a significant increase in defaults is inevitable. Furthermore, we realize that corporate earnings and cash flows have not been exceptionally robust with much of recent performance gains coming from cost cutting efforts rather than revenue or margin gains.

Market forces, however, which include exceptionally high levels of capital availability, low interest rates and weak loan structures will likely keep the default rate low for most or all of 2014 and possibly 2015. Assuming, of course, no exogenous event disturbs these market conditions.

As restructuring professionals, we believe strongly that "bad management knows all cycles" and, therefore, that current market forces are only masking and delaying the inevitable. The question that we constantly ask is: when businesses stop being artificially propped up and the *'stuff'* finally hits the fan, will it be too late to fix these companies and how much will recovery rates suffer? If your business or your borrower is not facing a near term default but performance also isn't where it should be, you should consider bringing in an experienced and trusted advisor to help identify issues and make fixes before it turns into a real crisis.

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[1] *Shared National Credits Program 2013 Review*, September 2013
[2] S&P Capital IQ Leveraged Commentary & Data, *High-End Middle Market Lending Review*, 3Q 2013
[3] S&P Capital IQ Leveraged Commentary & Data, *Leverage Lending Review*, 3Q 2013
[4] S&P Capital IQ Leveraged Commentary & Data, *High-End Middle Market Lending Review*, 3Q 2013
[5] S&P Capital IQ Leveraged Commentary & Data, *High-End Middle Market Lending Review*, 3Q 2013