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Leveraged loans

Why parts of Wall Street are fretting over 'toxic' loans

Leveraged loan investor says private equity firms are abusing their market power

ROBIN WIGGLESWORTH — NEW YORK

Steve Ketchum is not happy. The hedge fund manager is a big investor in so-called leveraged loans, a corner of the debt market that involves lending to riskier, lower-rated companies.

Mr Ketchum believes in the asset class. It makes up the bulk of the $21bn his firm manages. But he worries that heavy-hitting private equity firms are sabotaging the market by relaxing terms on the loans they are foisting on to investors.

"At some point they could kill the golden goose," he warned from his Park Avenue offices in New York. "If they push for more toxic loan structures and this affects default or recovery rates in a recession, the demand for leveraged loans won't keep up with future needs."

The US leveraged loan market has roughly doubled over the past decade to $1.1tn, according to the Federal Reserve's latest Financial Stability Report, as acquirers of companies — often private equity firms such as KKR, Apollo and Blackstone — have loaded their targets with as much debt as they think they can handle.

Globally, some $2.2tn of similar loans are outstanding, says the Bank of England, reflecting investors' thirst for income-generating assets in a world of ultra-low interest rates.

But deteriorating lending standards have raised eyebrows among regulators including the Fed and the International Monetary Fund.

The Financial Stability Board, a global body set up in the wake of the financial crisis, this year launched an investigation into risks emanating from the loans, which are arranged by big banks and bought by institutional investors like Mr Ketchum's firm, Sound Point Capital. Some top bankers, too, have sounded cautious notes.

"It'll be ugly for those companies if the economy slows down and they can't carry the debt and then restructure it, and then the usual carnage goes on," Brian Moynihan, chief executive of Bank of America, said last month.

'At some point, they could kill the golden goose'

Mr Ketchum said that some of the commentary on leveraged loans was too gloomy. He argued that the market, on the whole, is in better shape than it was before the financial crisis, thanks to private equity firms having to stump up more of their own money when they do deals. Moreover, most leveraged loans are now in steadier hands, like his, rather than sitting within banks.

Nonetheless, he is growing increasingly frustrated at private equity firms systematically stripping out legal protections known as covenants, to make the loans "covenant-lite". Before the financial crisis, about a quarter of the (much smaller) leveraged loan market was considered cov-lite, but it now stands at almost 80 per cent, according to Moody's.

"Covenant-lite is the scourge of corporate lending," he said. "If you lend someone money then you want all the rights you can get. We are more aggressive about saying 'No' these days."

The hedge fund manager says the two most "odious" abuses are adjustments to ebitda and the gutting of so-called restricted payments clauses.

Ebitda stands for earnings before interest, taxes, depreciation and amortisation, and is a commonly used measure of a company's operating profitability, before accounting for the way it is funded.

But some companies massage their ebitda higher with adjustments known as "add-backs", to make debt burdens seem lighter. If ebitda, used in the loan documentation to set debt limits, is inflated, the financial test ratios will be looser, reducing their effectiveness as a sign of trouble ahead.

When Blackstone bought Refinitiv, the data part of Thomson Reuters, for example, the ratio of debt to ebitda looked reasonable at 5.7 times. But stripping out add-backs — loosely-defined future activities to cut costs — the ratio rose to over seven times.

Many other deals have similar features. The average acquisition had a headline debt/ebitda ratio of 5.6 times last year, according to UBS, but if one excludes add-backs the average leverage was closer to 7.4 times. The average in 2007 was 4.5 times.

Restricted payments clauses, meanwhile, are limits on how much money company owners can extract from the business, which might threaten its creditworthiness. Ravenous demand among investors for leveraged loans means that some private equity firms are gutting these clauses to pay themselves big dividends.

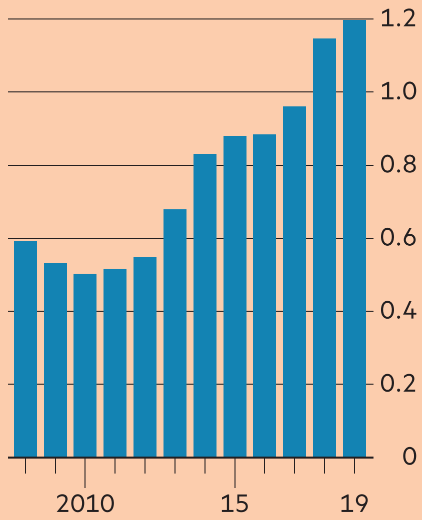
Some say that means there will be plenty of pain for investors in the next downturn. The leveraged loan default rates in the previous two major reversals — in the wake of the dotcom bust and the financial crisis — were about 25 per cent and 20 per cent respectively, with average recoveries of about 65-68 cents on the dollar, according to Pimco. However, in the next default cycle the investment group forecasts a default rate of 30 per cent and average recoveries of just 50 cents on the dollar.

The market could double or even triple in size over the next decade, reckons Mr Ketchum, a former media and telecoms banker at BofA. But not without more restraint from dealmakers.

"My friends who run private equity firms need to take a longer-term view on covenant negotiations," he said.

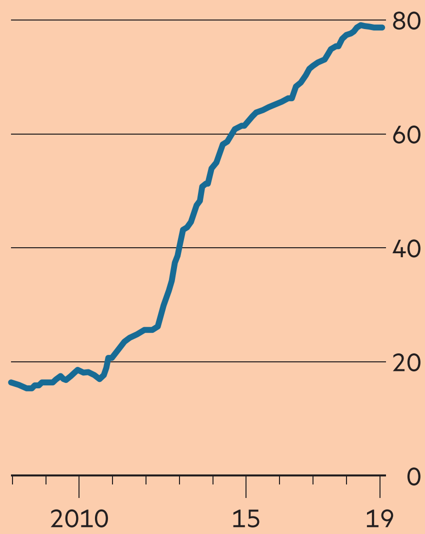
Issuance of US leveraged loans soars

Amount outstanding ($tn)



Share of US loans with 'covenant-lite' structures

Per cent



Sources: LCD; DBRS