Are We Back to 2007? (Last of a series)

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Predictions are tough, especially about the future. And after Thursday's Dow tumble, it's hard to dismiss outright doomsday forecasts that a credit apocalypse is coming soon.

For leveraged lending bubble busters, their canaries in the capital coal mine are leveraged statistics. Are we past 2007's high-water mark?

To be sure, we're hearing our share of scary stories. Like the 6.8x all-senior, covenant-lite, LBO financing for the less-than-$50 million-ebitda-issuer. And while these outliers are bound to excite the Chicken Little contingent, the overall data are less alarming.

As our *Chart of the Week* depicts, the share of 7x or higher LBOs over the past couple years comes nowhere near the levels breached in 2007. On average, S&P LCD says total debt to ebitda back then for highly leveraged transactions – so-called HLTs – was 4.9 times. Compare that to 5.0 times measured at 2Q 2014.

For middle market companies (less than $50 million ebitda), leverage is up from the last cycle. Comparable total debt to ebitda was 4.8 times back in 2007; today it's 5.2. That's somewhat surprising, given that midcaps historically carry lower leverage than their broadly syndicated counterparts.

The eye-catching stat, though, for both smaller issuers and the overall market, is *senior* leverage. That multiple has expanded to 4.45x (from 4.0x seven years ago) for all issuers, and a whopping 5.1x for the middle market (vs. 4.3x in 2007).

Today's middle market leverage – 5.1x senior/5.2x total – means these transactions include virtually no junior debt. The reason is clear: the second-lien market has, at least for larger, syndicated midcap deals, effectively disintermediated mezzanine debt.

This development coincides with the rise of yield-driven BDCs, finance companies, and middle market credit opportunity funds. These providers offer sponsors unitranche options at leverage levels previously only senior/mezz structures would go.

Indeed, it's hard to know where senior-stretch loans end and unitranche begins. Traditionally, a senior-stretch is a quarter or half-turn higher leverage than senior debt with sub debt below, in exchange for, say, 50 bps added spread. Unitranche offers the same leverage as two-tranche structures, at a cost that blends senior and mezz pricing.

But with competition for deals intense, the line is blurring. Is a 5x all-senior deal priced at L+650 a unitranche or stretch-senior? For high free cash-flow issuers, lenders may point to projections showing lower Year Two leverage (e.g. 4.0x), arguing the company will perform its way to the better pricing.

Speaking of leverage, the media often ignores contributed equity to capital. Yes, purchase price multiples rival 2007 levels, but sponsors are also injecting more equity. Seven years ago, per S&P, only one-third of LBO capital was equity; today, it's 37%.

So, in general, evidence suggests 2014 is no 2007. Supply/demand dynamics and deal metrics point to being in a sell-side friendly market that could last for a while. Things may loosen and tighten, but as far as end-of-the-world calls go, it's Apocalypse Later.