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State of the Loan Market (Second of a Series)

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The backdrop for US credit got a boost from several corners last week. First, the nomination of Jerome Powell to be the next Fed chief ensured monetary policy would be, if not unchanged, at least in experienced hands.

Also, the October labor report – 261,000 new jobs added– came in pretty much where economists expected. The jobless rate continues to fall, now resting at 4.1%. And remarkably doing so without sparking wage growth, helping keep inflation in check.

Finally, the House Republicans' tax proposal lifted hopes in the business community that a stimulative fiscal program getting passed this year was a theoretical possibility.

Add these developments to the prior week's encouraging data on third quarter GDP, showing the US economy racked up the second straight quarter over 3% or better growth. A pretty good recipe for sustained support of the capital markets.

For credit investors, this is a mixed blessing. Take bonds, for example. High-yield bond spreads have dropped to about 340 bps, closing in on the post-crisis low 335 bps reached in 2014. That's echoed by falling loan spreads in the broadly syndicated market. But as a relative value matter, secured loans at L+375 still look fairly attractive.

Total leverage for large cap buyouts has nudged above six times ebitda for the first three quarters of 2017, with middle market LBOs right at six times. Those levels had been trending down somewhat since the imposition of Leveraged Lending Guidelines in 2013. But this year they've ratcheted back up.

Also climbing has been first-lien leverage; for midcap buyouts that metric so far in 2017 is 4.84x, per Thomson Reuters LPC. That's slightly north of where their broadly syndicated cousins are weighing in (4.81x). To some extent this is demand-driven. First-lien debt capital is plentiful, and managers are eager to put it to work.

It's also motivated by private equity sponsors who are witnessing purchase price multiples persist in their upward trajectory; now well over ten times ebitda. To keep financing costs down, sponsors are eliciting senior-stretch options. Blended costs of first-lien/second-lien structures are now competitive with unitranches.

Some good news for investors: the percent of equity to capital remains around 40% for large cap buyouts, and over 45% for middle market LBOs. These numbers are well above pre-crisis equity contributions, supporting the thesis that lenders are better protected going into a theoretical next downturn than they were in 2007.

Whatever attractive loan features investors might enjoy going into a new primary deal can evaporate when the loan is repriced or refinanced. As spreads contract and structures weaken, issuers want to know they have a market deal.

Repricings have slowed from the heady first quarter, around $225 billion for all loans, to $60-ish billion last quarter. It's painful to watch good assets become less attractive. As we're fond of saying, the loan market giveth, and the loan market taketh away.