# State of the Loan Market (Last of a Series)

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In what was the highest price ever paid for a painting, Leonardo da Vinci's "Salvator Mundi" sold last week for $450.3 million at a Christie's auction, beating by a wide margin the $179 million forked over two years ago for Picasso's "Les Femmes d'Alger."

The price tag also topped the entire building cost of New York's new Whitney Museum ($422 million). The satirical newspaper, *The Onion*, weighed in with a headline: "Buyer of $450 million Da Vinci Painting Sort of Assumed it Would Come with Frame."

Loan buyers in the leveraged market must have similar feelings of being short-changed this year. As yields have compressed and leverage crept up, investors are scouring the current pipeline for value. That search is complicated by loan structures weakening with a broad brush.

At the heart of this erosion is the definition of ebitda. As we've discussed at length in this space, sponsors are stretching cash flows to include various add-backs and pro forma adjustments to justify higher purchase price multiples. As our *Chart of the Week* highlights, those multiples are heading towards 11x on average for the overall market.

And it's not just affecting leverage covenants, to the extent that a maintenance test is even featured in the credit agreement. As an upcoming *Lead Left Spotlight* guest will point out, inflated ebitda is also distorting other covenants such as builder baskets, asset sales, debt incurrence, dividend allowances and excess cash flow sweeps.

Besides news from the art world, another surprise was the bipartisan support from the House Financial Services Committee for a bill that, among things, gives BDCs the ability to use up to 2:1 leverage to improve the yield of the assets in which they invest.

While some BDCs have already found ways around the 1:1 restriction, others might take advantage of the additional flexibility by buying lower yielding assets. With leverage, those loans could now meet the vehicles' higher return parameters.

Meanwhile the portrait of the bond market wasn't pretty. Cash poured out of retail high-yield funds to the tune of $4.4 billion, putting total outflows at about $13 billion for the year. That came in response to market jitters about the telecom sector, mostly centered around slowing growth and increased competition among wireless providers.

While no one thinks this marks the end of the bull credit market, it reminds us corrections are often triggered by emotions. Because bonds are unsecured and fixed rate, holders are more sensitive to rate or cycle worries. With the structural erosions being suffered by leverage loans in general, their value relative to bonds blurs.

This trend helps middle market loan buyers appreciate the benefits of that asset class. Traditional midcap agreements still have a leverage maintenance test. And the smaller the issuer, the more likely some form of junior debt will be found in the capital structure.

So while masterpieces are scarce in the loan world, experienced managers don’t mind paint-by-numbers. As long as the numbers makes sense.