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You Can Take it With You

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Years ago the humorist Robert Benchley was traveling in Italy on summer vacation. Upon arriving in Venice, he cabled his agent: “Streets flooded. Please advise.”

In a similar vein, leveraged loan investors should not be surprised at effects of ample liquidity flowing through credit markets today.

As we head into the second quarter’s final weeks, it’s clear sponsors and lenders aren’t slowing down in their drive to deploy dollars. It’s evident competitive juices haven’t dried up either. Whatever structure, term, price, spread, or covenant that needs to be stretched to win a deal, will get stretched.

In some cases, features typically reserved for the best and biggest issuers are coming down market to smaller mid-cap companies. In others, even issuer-friendly elements not often found in broadly syndicated loans are surfacing as frothy conditions continue.

One ingenious concept from the pre-crisis era making a comeback is portability. The idea is simple: Offer a financing structure to a sponsor that can be passed along to the next buyer without triggering a change of control provision in the credit agreement. Providing the borrower is in compliance with all covenants, a new private equity owner can carry on, dragging lenders along whether they like the new owner or not.

According to LevFin Insights, eight such deals, or “precaps,” surfaced in 2017, and another eight this year. One example is a dividend financing with precap language requiring the purchasing sponsor to have at least a $1.0 billion fund. Additionally, it states a change of control must occur within two years of closing the recap. Finally, in typical terms, no event of default must exist, leverage must be no more than the existing structure, and the new sponsor must own at least 51% of the Company.

“There is a lot of variety in the parameters we’ve seen on portability,” says Jessica Reiss, the head of leveraged loan research at Covenant Review. “It’s really difficult to say what is or isn’t market. In some cases, it’s almost as though anything goes. Assuming the deal sells.”

Lenders are generally protected in two ways, she continues. First, to keep the creditworthiness of the borrower no worse than it is today, and second, to maintain the quality of the new sponsor roughly at that of the former owner. Within those parameters, though, there’s a spectrum of outcomes.

For example, the sunset period during which the change of control is permitted can be anywhere from one, two or three years, to forever.

So far these have been larger issuers, but that may change. With direct lenders’ hold levels at record highs, what “the market” thinks is less relevant. One envelope-pushing deal creates a precedent for others to follow. And unfortunately subsequent candidates tend to be less deserving.