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Half-Time Report (Last of a Series)

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Every now and then stuff happens in leveraged lending that reassures us things we've learned about the market are actually true. Such was the case last Friday when a big bank credit trading desk noted unusual data on retail loan fund flows.

Weekly outflows of $3.5 billion had been reported. That would have been a record, far in excess of the $2.1 billion set seven years ago. Rather than dutifully passing this along, however, the analysts immediately expressed doubt. They cited contrary evidence – selling activity in the secondary market was quiescent, buyers were keeping up a steady beat, and institutional investors would have remarked about it.

"Perhaps it was caused by Martians," one trader suggested. Nothing extraterrestrial, but sure enough, a correction was quickly issued – $151 million of *in-flows*. Order in the universe restored."

We cite this as supporting evidence that loan supply and demand are inextricably linked. If $3.5 billion in demand *had* been removed from the broadly syndicated market in one week, a cascading series of events would have whipsawed prices and spreads. Nice to see a live demo that loan behavior is more science than science fiction.

Meanwhile, as the third quarter gets underway, new deals continue to appear on the horizon. And while the 4th of July crunch has subsided, there's a reasonable supply building for the post-Labor Day period. That should temper some of the worst structural and pricing excesses on the sell-side.

Nevertheless, sponsors have available at least two distribution options for more liquid, large cap financings. They can get a debt rating, go cov-lite, and have an investment bank blow out the deal in the institutional market. When funds are hungry for assets, you can usually get the cheapest spread, highest leverage, and loosest structure.

Or, under less certain conditions, the issuer can avoid syndication risk altogether (if the deal is sized right) and club it up with direct relationship lenders. The latter execution typically requires a covenant, a bit more yield, and sometimes a tad less leverage. But it offers certainty of execution. The former is market-exposed.

During normal times institutional appetite can serve as the saucer to the loan market's cup. When cash is plentiful, arrangers can go wide and roadtest aggressive terms. If funds accept them, arrangers can reduce allocations and fit everyone into the cup. If they push back, arrangers can tweak whatever terms are needed to fill the cup.

For example, a negative rating surprise, such as a triple-C, might make the loan ineligible for certain CLO baskets. Investors will then either demand a higher yield, or pass altogether. If the market smells a troubled deal, it could push spreads and OID significantly wider than if the loan had launched higher to begin with.

As direct lenders expand their one-stop capabilities, including underwriting and higher hold levels, the non-syndicated route could become an increasingly attractive option as the second half of the year unfolds.