Splash Zone

THE LEAD | August 1, 2018

To the best of our knowledge, the village of Innaarsuit, Greenland (pop. 169) is not on any "Best Summer Vacation" lists. Being in the Arctic Circle, it's cold and dark most of the year. Not much exciting going on. But that has changed in a dramatic fashion.

Last month an iceberg weighing 11 million tons parked itself next door. At 300 feet high, it rivals the Statue of Liberty and is visible from space. If pieces start sliding off, scientists worry it could swamp the town. "It's not a peaceful process," one remarked.

We took note recently of similar concerns in the leveraged loan market; specifically, S&P LCD's just-published piece in their weekly wrap on middle market recoveries.

Numerous *Lead Left* columns have highlighted today's weakening structures. While the variety of terms being chiseled away covers a broad spectrum, they come in two basic areas.

The first is the definition of ebitda, which has become diluted through add-backs and pro forma adjustments. The second is incremental debt. Here we've seen that the opening balance sheet debt is just a starting point. Private equity owners seek to build into credit agreements allowances for additional financing capacity. Those debt baskets provide for growth for, as one example, add-on acquisitions.

Given these erosions, the proliferation of cov-lite in the middle market has given investors pause. According to S&P about 45% of midcap issuance in the second quarter was cov-lite. What does lack of a debt-to-ebitda test mean for loan recoveries if those loans default?

Rating agencies and data reporting firms have long held that the middle market, in general, sports higher recovery rates relative to broadly syndicated loans. This is due to a variety of reasons. First, smaller issuers tend to have less complex financing structures. Second, more midcap borrowers elect organized restructurings, rather than go the Chapter 11 route which can be fraught with uncertain outcomes.

But most importantly, middle market loans are held by like-minded, buy-and-hold lenders. They don't trade out at the first sign of a performance hiccup. Their historic sponsor relationships align everyone's incentives to work together for an outcome that maximizes lender and shareholder value. That results in better recoveries.

Through March 31st, S&P's data show the average discounted recovery for middle market loans is 62%. That's higher than the 59% number for the most liquid loans. The real question is what impact does more cov-lite for midcaps have on recoveries.

BSL cov-lite has historically gone to the better credits. As such, those recoveries have been higher than the overall market. But are only the best midcap credits cov-lite?

Private credit managers worry that, when we hit a downturn, middle market cov-lite loan values won't hold up as they have in prior recessions. In a distressed situation, without a financial test, investors would be stuck on a melting ice cube.