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Third Quarter Report (Last of a Series)

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As the year has progressed, there's been a growing bifurcation between the level of activity from middle market pure loan buyers and that of larger credit managers.

Funds with less capacity have limited origination capability. They typically get product from loan syndicators, only able to hold tickets in the $10-40 million range. By contrast, a select club of direct lenders are sourcing product directly from relationship sponsors, and are able to comfortably hold north of $100 million per transaction.

The disparity in these strategies is driven by two trends. First, fundraising has enhanced the ability of managers to hold a greater loan commitment among multiple pockets – Cargo Pants! – without compromising borrower diversity per vehicle.

At the same time, private equity firms are trimming back the number of lenders they choose to deal with. We spoke to one Midwest sponsor who told us, "Yes, we're focused on getting the most out of our current relationships. Things change. Some lenders are not as responsive as the competitiveness of our market has sharpened."

Another principal at an Mideast sponsor agreed. "The ability to speak for the entire financing is critical. It's also helpful to be able to offer top-to-bottom structures, including unitranche. Finally, being constructive on credit is what our firm values. Everyone has capital. Can you distinguish yourself by being creative?"

"Creative" in this context, means flexibility. That involves wider covenant cushions, ebitda add-backs, and acquisition capacity. As purchase price multiples rise and auction processes become more competitive, sponsors increasingly seek their lenders to help win deals, building platforms for growth to lower those pro forma multiples.

All this is to say that for the balance of 2018, lenders with greater capacity and deeper relationships will see their deal flow expand, while those with smaller pockets (not even Cargo Shorts) and that rely on loan syndication for flow will see activity diminish.

The overall fourth quarter backdrop for leveraged loans continues to be productive. Rising Libor rates will enhance the attractiveness of loans for investors. Range-bound spreads will chill refinancings, but support new buyouts. And the economy looks to be in good shape, despite what looks like a significant correction underway in the stock markets.

There's also plenty of uncommitted private equity funds poised to deploy. Sponsors admit that, given where multiples are, this is a hard time not to sell. And with private equity buyers continuing to raise funds, there's incentive to put existing capital to use.

As we've covered in the past two weeks, there's a good balance of loan supply and demand going into the final quarter. But as always, making the right investment decisions in the current environment depends on experienced asset managers. The key is knowing when potential risks can turn into real defaults and losses.