THE LEAD
https://theleadleft.com/second-thoughts-first-series/

Second Thoughts (First of a Series)

THE LEAD | January 14, 2015

We noted with amusement a tidbit in Friday's WSJ on professional cuddling. Apparently a growing number of fully clothed people are paying snuggle experts for services that include squeezing, tickling, and bear-hugging. "I felt transformed," one client reported.

Besides trying to wrap our brain around the fine distinction between this activity and…well, others, we were reminded of similar unintended consequences between unlikely bedfellows; namely, first and second-lien loans in the leveraged loan market.

For those needing a quick refresher, second-lien term loans are secured, but take a subordinate position to first-lien loans in the assets of the borrower. These tranches grew in popularity during the Great Bull Loan Market that peaked in the first half of 2007, often replacing high-yield bonds in larger deals, and mezzanine debt in smaller ones.

Providers included hedge funds, credit opportunity funds, and select asset managers looking for higher yield product. Second-lien appealed to issuers who liked the benefit of debt priced cheaper than traditional mezz, required no equity give-up, and was pre-payable (albeit with make-whole fees).

As our *Chart of the Week* shows, seconds returned after the Great Recession, with issuance peaking in the middle of last year. Then quarterly volume declined steadily, from $12.5 billion in 2Q, to $8.1 billion, to $4.2 billion (per S&P Capital IQ).

Reasons for the evaporation of this asset class are several. First, the relative value dynamics for second-lien capital providers have changed. During the first half of 2014, institutional first-lien spreads contracted as supply-demand technicals favored issuers.

As top of the capital structure costs dropped, so did those of the layer below. All-in second-lien pricing, which historically hovered at 10%, slid to 9%, and below. Depending on the tranche size and rating, first-lien participants were urged by syndicators to take pro rata slices of the second, leaving less product for the traditional buyers.

At the same time, credit structures were deteriorating, both in terms of leverage and deal terms. According to S&P, the average first/second-lien leverage rose to 4.10x/5.83x last year (versus 3.67x/5.25x in 2013).

Oil changed all that. With volatility re-introduced to market dynamics and retail cash leaking out of mutual funds, second-lien appetite dried up. In the face of an uncertain economic outlook, seconders had less interest in the tail end of a highly leveraged deal. At least, at the price syndicators were offering. "Second-lien guys just aren't there anymore," one trading desk veteran told us.

As so often happens with sudden market shifts, the sell-side was caught flat-footed. Deals structured earlier with issuer-friendly terms and flex no longer met investor demands. Arrangers couldn't distribute paper without offering big discounts, which in some cases they did.

For middle market transactions, there’s been one surprising beneficiary of this turmoil.

Next week: The resurgence of mezzanine debt.