When Senior Debt is Not Senior Debt

THE LEAD | March 30, 2016

Last Saturday a friend of ours took advantage of the spring-like weather, wading upstream from his house. Armed with his son's $14.99 Shakespeare® Salamander rod, a can of worms, a six pack, and a cigar, he sat on a log, waiting for a nibble.

Three hours – and zero nibbles – later, a man in a motorboat put-putted up. "I'm with the environmental office," he said, pulling out some ID. "Do you have a license to be fishing here?" he asked. My friend, laughed, incredulous. "You call *this* fishing?"

Similar challenges face capital market participants on what defines senior debt.

The traditional concept of senior debt refers to the layer of debt – historically 3-4 times Ebitda – that's secured by the assets of the company and positioned at the top of the capital stack above other debt. That moderate senior leverage represents the amount of debt that can be substantially repaid during the life of the loan through a company's free cash flow or can be comfortably repaid upon a sale of the company.

In those cases, the junior tranche was typically mezzanine, unsecured, and subordinated to the senior. When second lien began replacing mezz, the lines of what is senior debt blurred. Here was a liability that shared collateral with first lien holders!

Matters turned more complicated when loan arrangers stretched senior debt leverage into mezz territory. Better companies (the theory went) can handle over four times senior debt to cash flow. Even in a downturn these borrowers could still be sold at a multiple of at least five times cash flow, thus allowing senior lenders to get out whole.

We know what happened. When the Great Recession hit, many companies struggled with the higher leverage. And higher purchase price multiples failed to materialize. As Jamie Dimon famously said, selling a house is not the same as selling a house on fire.

Now all-senior deals are stretched into financings where there is no junior debt below the unitranche providers. Leverage-wise these transactions go beyond comparable structures including mezz. In a workout, when ebitda is down, and leverage goes above six times, can lenders sell these companies and still get their money back?

To make labels more confusing, funds are being raised targeting double-digit returns, yet are called "senior debt" or "direct lending" or "private credit." To achieve such yields, these funds focus on non-sponsored borrowers, smaller companies, or turnarounds. Veteran loan managers know the loss metrics in those situations are higher than for middle market cash flow loans to private equity backed businesses.

As our *Chart of the Week* shows, returns do not always make up for riskier strategies. While special situation funds, as an example, have had modestly higher returns than direct lending, the cost has been at a much higher risk.

With $50 billion of capital raised for debt funds last year, the stakes are higher for senior lenders of all stripes. It’s never been more important to ask, as our fishing buddy would have put it, “You call *this* senior debt?”