Debt Markets:

Taper Your Enthusiasm – An Update

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The debt markets have outperformed themselves during 2013, harkening back to the boom years of 2005 through 2007. That is, if you measure performance by the amount of liquidity in the market.

In the context of an overall low interest rate environment, pension funds, insurance companies, mutual funds, hedge funds and other alternative capital sources have sought to invest in higher-yielding instruments provided by the bond market and the broadly syndicated loan market. For instance, the second lien loan market, notably absent during the latest financial crisis, is back with renewed enthusiasm. Credit demand has continued to outstrip credit supply, which has led to mostly opportunistic transactions, consisting of re-financings, re-pricings and to a lesser extent dividend recaps. Underlying the low interest rate environment is the Federal Reserve's continued bond-buying program, known as quantitative easing. As a case in point, when the Federal Reserve hinted that it would start to taper the quantitative easing during the spring, the bond market went through a sell-off in May and June. The big unknown is not *whether* the tapering will occur, but when and at what pace. A return to more normalized interest rates is inevitable. The question is what volatility will this engender.

As a consequence of unmet credit demand, market terms for credit documentation have over time become increasingly borrower/issuer friendly in the market for high-yield and large syndicated financings. Covenant-lite structures, permissive add-backs to EBITDA to calculate financial covenant tests, computation of leverage ratios on a net debt basis, equity cures, and extensive, incurrence-based carve-outs to the negative covenants have become commonplace.

This has particularly been the case in re-financings and re-pricings, which are most often arranged on a best efforts basis, allowing arrangers and underwriters to test the market with permissive deal terms. The investment thesis for institutional investors in a highly liquid market are different from those of the traditional participants in the middle market finance space, such as banks, mezzanine funds and finance companies. These mostly have a buy-and-hold attitude based on often longstanding relationships with the borrowers/issuers and their stakeholders.

Due to the aforementioned market forces, borrowers and issuers in the middle market have sometimes questioned the need for relationship-based sourcing of financing, as the flexibility in the documentation for large syndicated financings has increasingly found its way to middle-market transactions, including the lower end of the middle market. This, in turn, has forced the traditional middle-market financing sources to offer more flexible debt structures targeted to the specific needs of borrowers and issuers, such as "stretch" first lien debt, secured mezzanine and "cross lien" financings, unitranche or "synthetic" mezzanine facilities, and holdco indebtedness.

The outlook for the debt markets in the fall and winter of 2013 is difficult to forecast. In the absence of any major macro-economic

events, a continuation of the trends from the first half of this year is likely, unless the Federal Reserve starts to execute on its promise to taper the quantitative easing if the economy improves. Note that the sustained amount of liquidity and the availability of debt and equity capital has not led to increased M&A activity. Absent a number of marquis transactions, the first half of 2013 was quiet compared to the tax-driven activity during the last quarter of 2012. Stock market gains have made targets less attractive, and, because of historical EBITDA battered by the recession, harder to value, leaving buyers and sellers apart on valuations. A tapering could ultimately create volatility and drive down stock market prices, bringing buyers and sellers closer together.

About the Author

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