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Rising benchmark raises borrowing costs for companies

Higher three-month dollar Libor also affects vast universe of collateralised loan obligations

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Companies face their first increase in borrowing costs since the financial crisis as incoming rules for prime money market funds spur higher short- term interest rates.

Payments on floating rate loans issued by dozens of companies are set to increase asUS dollar Libor for a period of three months has risen above 0.75 per cent.

This level, alongside interest rate floors set at 1 per cent, is used on more than nine-in-ten of the loans that comprise the $880bn S&P/LSTA Leveraged Loan Index.

Analysts and investors expect Libor to continue climbing as new rules governingprime money market funds are fully implemented in October. That has reduced participation in commercial paper, pushing up short-term borrowing rates including Libor.

“As Libor crosses these floors, the amount of interest the companies have to pay is going to creep up,” said Meredith Coffey at the industry association LSTA.

The increase in Libor past 0.75 per cent will affect loans issued by Valeant Pharmaceuticals, office supply retailer Staples and fragrance and cosmetics groupCoty, which will reset higher when quarterly interest payments are due in the coming months. The loans include a floating rate component — in this case Libor — and a spread to compensate investors for the underlying credit risk.

“[Rates] will start floating after a very long time and it will be interesting to see how it shakes out,” said Neha Khoda, a credit strategist with Bank of America Merrill Lynch. “For some companies it won’t matter, it will be a drop in the ocean. But for some with limited cash flows, it will be significant.”

The rise will also affect the vast universe of collateralised loan obligations — bonds backed by leveraged loans. For CLO investors in the lowest tranches, known as the “equity” slice of such deals, the impact can be significant.

Equity investors typically receive all income left over after other, more senior, holders in the CLO have been paid. In exchange for the potential upside, these holders must tolerate the greatest risk of loss should the underlying loans default.

As Libor has slowly crept higher, the income that CLO portfolios have collected on corporate loans with floors has stagnated. As the Libor rate paid to senior tranche holders has increased, that has left less to pass on to equity holders.

“The increase in Libor is a net negative for equity holders because it erodes the yield pick-up,” said Oliver Wriedt at CIFC. “The rate has to get above 1 per cent before that negative effect is neutralised.”