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Leveraged Loans Are Back and on Pace to Top Pre-Financial Crisis Records

Investors worry this could pressure financial markets if global economic expansion fades

Toys ‘R’ Us offered a reminder of the risks of piling on debt when the company filed for bankruptcy protection this month. PHOTO: LM OTERO/ASSOCIATED PRESS

By Christopher Whittall
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Lending to the most highly indebted companies in the U.S. and Europe is surging, a development that investors worry could pressure financial markets if the global economic expansion starts to fade.

Volume for these leveraged loans is up 53% this year in the U.S., putting it on pace to surpass the 2007 record of $534 billion, according to S&P Global Market Intelligence’s LCD unit.

In Europe, recent loans offer fewer investor safeguards than in the past. This year, 70% of the region’s new leveraged loans are known as covenant-lite, according to LCD, more than triple the number four years ago. Covenants are the terms in a loan’s contract that offer investor protections, such as provisions on borrowers’ ability to take on more debt or invest in projects. Toys ‘R’ Us offered a reminder of the risks of piling on debt when the company filed for bankruptcy protection on Monday. The toy seller’s chief executive said in court papers that Toys ‘R’ Us had been hampered by its “significant leverage.” Its $5.3 billion in debt included a large number of leveraged loans and high-yield bonds.

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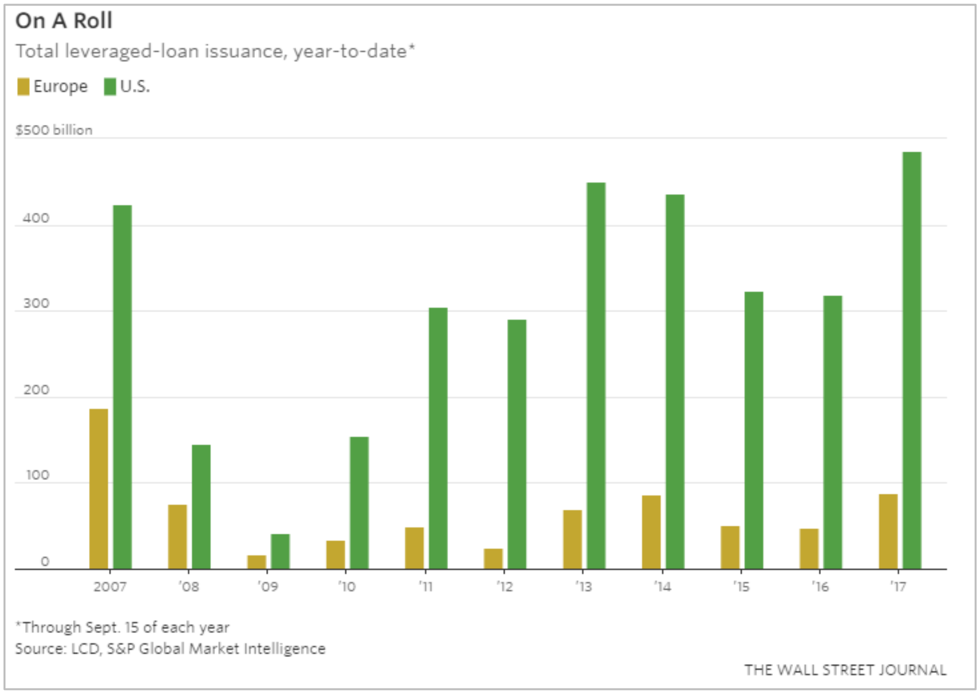
Even though default levels are currently low, and global growth has been picking up, the lending boom could prove troublesome when market conditions change or the economy slows.

“If feels like the market is getting frothy,” said Henrik Johnsson, co-head of global debt-capital markets at Deutsche Bank AG . “We’re overdue a correction.”



Before the financial crisis, the boom in leveraged loans was one of the signs of markets overheating. As the crisis intensified in 2008, investors in U.S. leveraged loans lost nearly 30%, according to the S&P/LSTA Leveraged Loan Index.

Regulators are taking note. In its last quarterly report, the Bank for International Settlements noted the growth of covenant-lite loans and pointed out that U.S. companies are more leveraged than at any time since the beginning of the millennium. That could harm the economy in the event of a downturn or a rise in interest rates, said the BIS consortium of central banks.

The leveraged loan market has long been favored by private-equity firms raising cash to fund company takeovers. Investment banks arrange the loans and typically parcel them out to other lenders and investors.

Now, investors are jumping in because central bank stimulus has pushed down returns across bond and equity markets. In the U.S. alone, investors have poured $16.9 billion into loan funds this year, taking total assets to a record of $141.2 billion at the end of August, according to Thomson Reuters Lipper.

In Europe, the pipeline for leveraged loan deals still to be sold was €7.6 billion in August, according to LCD, the highest level in seven years.

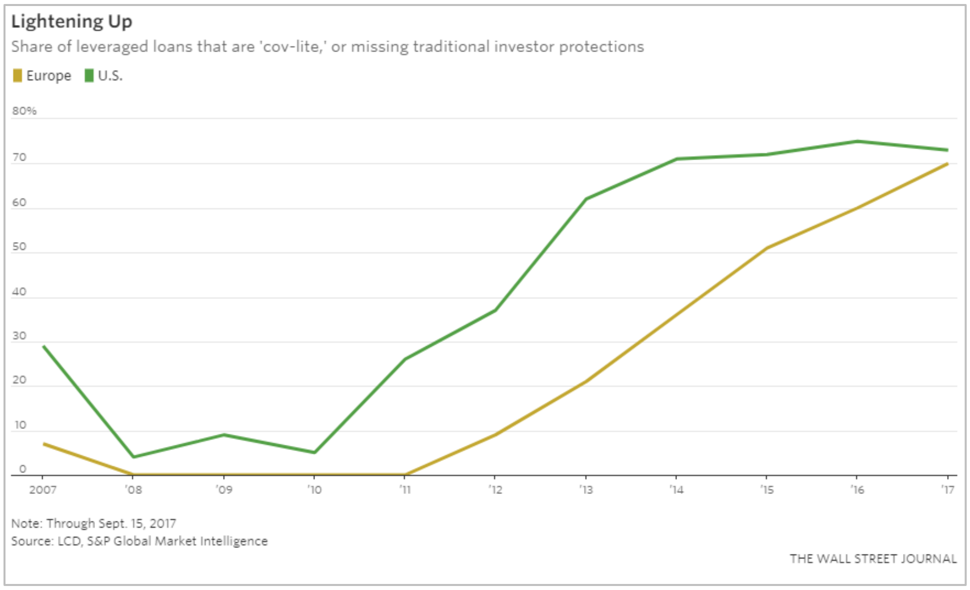
In the U.S., loans issued to fund leveraged buyouts from private equity companies this year total $88.5 billion, up 74% from the same period last year and on track for the largest amount since 2007. High-yield bonds are trading at their highest levels since before the financial crisis.

"When you have more money seeking loans and bonds than there are new [deals], you see leverage creep up and covenants" relax, said Jeff Mueller, a portfolio manager at Eaton Vance in London.

Historically, most loans in Europe have been subject to covenants. Covenant-lite, or "cov-lite," was long the standard in the U.S.

Loan terms are now "more aggressive here in Europe," said Christopher Kandel, a partner at law firm Latham & Watkins LLP, citing provisions giving borrowers greater flexibility to pay out dividends or incur additional debt.

Cov-lite loans barely existed in Europe before the financial crisis. "That will be the test for investors," said Taron Wade, a director at S&P Global. "How they perform through the cycle."



Some fund managers, meanwhile, are uncomfortable with increasing levels of leverage in the market.

That is particularly true in the U.S., where nearly a third of loans to private-equity backed companies this year are leveraged six times or more, according to LCD's calculations of companies' debt to earnings before interest, tax, depreciation and amortization. That is despite 2013 guidelines from U.S. regulators, including the Federal Reserve, on loan underwriting stating that leverage of more than six times "raises concerns for most industries."

Five of the six largest new loans backing leveraged buyouts this year have exceeded those levels, according to Dealogic and Moody's Investors Service.

The largest was a $3.15 billion loan taken earlier this year by Team Health Holdings Inc. to fund Blackstone Group LP's leveraged buyout of this health-care provider. In January, Moody's estimated that Team Health's leverage was at around 7.5 times.

Moody's also estimated that insurance broker USI Insurance Services had leverage of just above eight times following its takeover by KKR & Co. and Caisse de dépôt et placement du Québec that was followed by $2 billion in leveraged loans.
Toys 'R' Us illustrates how crushing debt loads can overwhelm companies and inflict losses on investors. Moody's warned in a report in June that the toy maker was "hamstrung by the significant levels" of leveraged buyout debt that still remained despite a 2016 debt exchange—one of several the company engaged in with loan and bondholders to help manage its debt burden.

Toys 'R' Us's last round of dollar financing in public markets came in October 2014, according to Dealogic, when it issued $1.3 billion in leveraged loans at hefty borrowing costs. A $1 billion loan maturing in five years and five months was priced at a margin of 8.75 percentage points over Libor, according to Dealogic, while a $280 million five-year loan was priced at 7.25 percentage points over.

Other corners of the market are showing signs of overheating.

In the high-yield bond market, another area where riskier companies look to fund, the extra premium investors demand to hold these securities over haven U.S. Treasurys has declined around half a percentage point this year to levels not seen since 2007, according to Bloomberg Barclays bond indexes.

“If you get a spike in default rates, you’re patently not getting compensated in high yield,” said Zak Summerscale, head of credit fund management for Europe and Asia Pacific atIntermediate Capital Group .
Still, some argue the valuations in loans and bonds are justified by the benign economic environment.

Mike Freno, global head of fixed income and multiasset at Barings, said that while there are some troubled sectors such as retail, overall the companies in his loan portfolios aren’t showing “excessive leverage.”

Economic “fundamentals are very supportive,” he said.

Loans to fund buyouts from private-equity firms are still well below where they were before the crisis. So far this year, U.S. loan issuance used to fund leveraged buyouts is still 34% lower than in 2007. While leveraged buyout activity is on the rise in Europe, volumes are less than a quarter of their 2007 peak.

But there is increasing caution.

Beth Maclean, a portfolio manager at Pacific Investment Management Co, said she has been reducing risk by favoring larger and better capitalized loans with higher ratings.

“We are seeing increasing risks across the board in the loan market in Europe and the U.S.,” she said.

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