US Credit Strategy

Fed "Adjusts" Main Street Lending Facilities to Include More Leveraged Finance Issuers

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Changes to the Fed Main Street Lending facilities should be an incremental positive for high yield and leveraged loans. Allowing the use of adjusted EBITDA is especially beneficial to loans, but we believe almost half the market will still be prevented from accessing the facilities.

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The Federal Reserve announced several changes to the Main Street lending facilities and further clarifications on a number of points in an associated FAQ document. In general, these changes should expand the number of companies eligible within the high yield and leveraged loan markets, although they are still unlikely to reach the most leveraged entities. What was an implicit link between these facilities before and the Leveraged Lending Guidelines has also become more clear in terms of the Fed's requirements for which companies can access the facilities. As a result, we do not expect a significant rally in lower quality from these changes, but recognize that B-rated companies with less than 6x leverage should benefit. Of all the changes discussed below, the clarification that lenders can use adjusted EBITDA could be the most positive, especially for the loan market.

We focus here on the Main Street Expanded Loan Facility (MSELF) as that is what most issuers in our universe would have access to since they already have outstanding facilities. The Main Street New Loan Facility (MSNLF) and the newly announced Main Street Priority Loan Facility (MSPLF), both with $25mn limits, will be less applicable for issuers in the high yield and broadly syndicated loan markets.

Some of the key terms that were updated:

- Size remains $600bn, although it is now shared between the three facilities.
- Eligible entities can have up to 15,000 employees or $5bn in revenue vs. 10,000 employees or $2.5bn in revenue previously.
- The loans will still be pari passu with existing loans but pricing is now Libor + 300bp instead of SOFR + 250-400bp (this does not include a separate one-time 75bp origination fee).
- Banks will still retain 5% of the risk as opposed to the 15% in the new MSPLF.

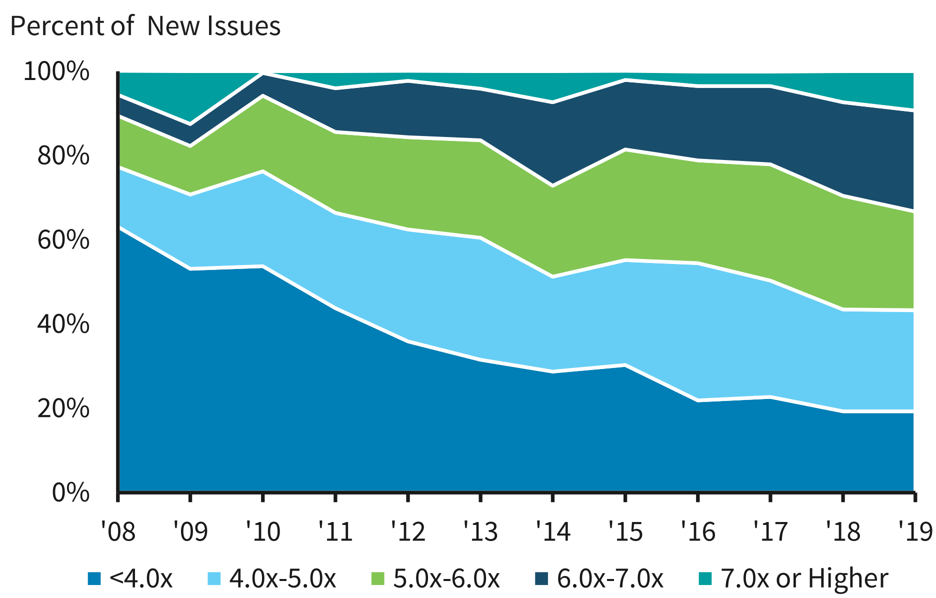
- Interest payments are deferred one year still and the amortization schedule is now 15% at the end of the second year, 15% at the end of the third year and 70% at maturity in four years, although prepayment is permitted at any time.
- The formula for calculating maximum capacity per borrower was changed to the lesser of (i) $200mn (up from $150mn), (ii) 35% of existing outstanding and undrawn pari passu debt (up from 30%), (iii) an amount that when added to existing outstanding and undrawn debt does not exceed 6x 2019 EBITDA
- EBITDA is defined as the metric which the Eligible Lender used for adjusting EBITDA in previous loans to the Eligible Borrower.
- The existing loan of the borrower must have had a “pass” rating in the Federal Financial Institutions Examination Council’s supervisory rating system as of December, 31, 2019.

Clearly expanding the amount of employees and revenue for eligible companies is a positive. In high yield we think that this takes the eligible universe from approximately half the companies to closer to two-thirds (before accounting for EBITDA and other restrictions). The loan market is tougher to calculate as we do not have enough public filers with employee and revenue data available for a reasonable estimate, but it is likely even higher than for high yield. Increasing the size to $200mn also should provide a better liquidity bridge for issuers needing this financing.

For the loan market, the clarification allowing for the use of adjusted EBITDA is likely to be the most important. We believe the language will allow lenders to base these calculations on the same adjusted EBITDA used for calculating financial covenants. Based on adjusted EBITDA, two-thirds of the new issue loan market fell below 6x leverage in 2019, whereas if we used unadjusted figures it would likely be no higher than 50% based on the average adjustment to EBITDA of approximately 20% in 2019 new issuance according to Covenant Review. The two-thirds number would seem to match the stipulation regarding the loan being rated “pass” as well. We assume this correlated with the definition of pass in the Shared National Credit Program. Using the latest results published by the Fed, FDIC and OCC in January, we believe 31% of leveraged loans were in the special mention and classified categories that would likely be considered non-passing. The Shared National Credit Program assessments are based on the Leveraged Lending Guidelines, which mentions 6x leverage as a limit. We believe the Fed found a way to effectively weave those standards into the MSELF. We note, though, that all our leverage stats only include funded debt and not undrawn revolvers. While we do not have comprehensive data on this, we would estimate that including these unfunded commitments could on average amount to an additional 0.5x-1.0x of leverage as per the MSELF terms and could mean that it is closer to 50% of the market that actually qualifies. For high yield, we focus less on the definition of adjusted EBITDA since LBO supply has only been a mid-single digit percentage of supply in recent years and that tends to be where the greatest adjustments occur. The number of companies under 6x leverage in high yield without adjustments is approximately 55% and it should be similar to the two-thirds for loans after some adjustments (but before counting undrawn revolvers).

Finally, there is the matter of the stipulations that come along with these loans. Investors have expressed concerns with respect to all the Federal Reserve programs that these restrictions may limit uptake, especially after some larger companies have returned funds from the Payment Protection Program (PPP) after negative publicity. While we do not debate that companies will likely carefully consider whether to go to the Fed for funding, we think this just makes these loans serve as a true backstop. Companies may, in fact, go to the market at rates higher than L+300bp to avoid the limitations, but those that could not access the market otherwise because they are in a particularly hard-hit industry could benefit greatly from access to this financing depending on the path of the recovery. There are several certifications for eligible borrowers, including that they can meet financial obligations for 90 days and do not intend to file for bankruptcy in that time, they will make commercially reasonable efforts to retain employees while the loan is outstanding and they will commit to the compensation, stock repurchase and capital distribution limitations of the CARES Act. These all put restrictions on a business and its owners (in the loan market that is often private equity), but are almost definitely a better option for equity than a bankruptcy filing, especially considering how off market L+300bp is for a stressed issuer today. Our belief that companies are open to taking these loans is buoyed by recent documentation changes we have noticed in many high yield new issues this month. The language can vary across indentures, but most bonds have an optional prepayment for up to 35% at $103 for a period of time with proceeds from the CARES Act or similar government funds. While companies will always prefer such an option, we do not think it would have made its way into so many deals if some did not think it could become reality.

FIGURE 1. New Issue by Leverage Cohorts



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