# GRANT'S

INTEREST RATE OBSERVER®

Vol. 36, No.14c | Two Wall Street, New York, New York 10005 • www.grantspub.com | JULY 13, 2018

# Tomorrow's debt hearings

The federal inquest into the credit smashup of, let us say, 2019 will not overlook leveraged loans. Testimony will uncover the facts that were as plain as day in 2018. That body of knowledge, plus a little extra, fills the essay in progress. Skipping down to the bottom line—and to allow for the odd exception to a heroic generalization—the trillion-dollar leveraged loan market is no place for the readers of *Grant's*.

Since the very word "loan" connotes leverage, the inquisitive congressmen may wonder, What is a "leveraged" loan? Here is a blessed case of a simple answer attached to a simple question. Leveraged loans are floating-rate, secured loans to speculative-grade borrowers. They earned a reputation for safety in the crucible of 2008.

The reputation flatters the no-longer-exemplary asset. As the M&A craze has ballooned the supply of leveraged loans, ultra-low (but gently rising) interest rates have pumped up the corresponding demand. In the first half of 2018, $90 billion of new issuance pushed the volume of outstanding loans to $1.04 trillion, up from $554 billion in 2007, according to S&P Global Market Intelligence's LCD unit.

"You have no call protection, and you have no covenants. You don't get the upside, and you get all the downside," says David Sherman, paid-up subscriber and principal of credit-specialist Cohanzick Management, LLC, of the leveraged loan-value proposition (he will make an all-star congressional witness). Successful borrowers call their loans before maturity to reset the interest rate lower and the covenant protection looser. The least successful borrowers default. The corporate debtor-creditor relationship has long been a one-sided, almost abusive, affair. You wish that Oprah would mediate.

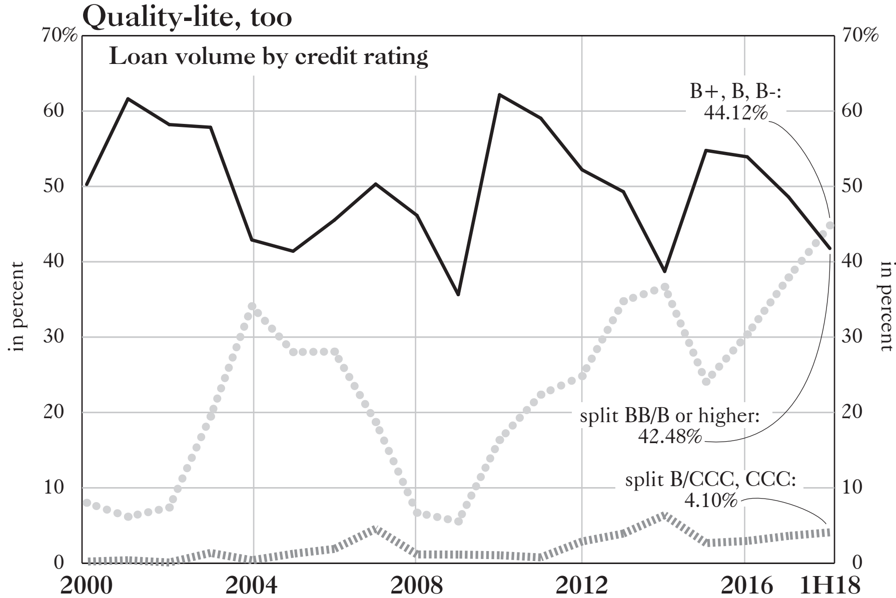
New in the past half-decade is the decline of the contractual protection furnished by loan covenants. Mostly, it's not there, but, increasingly, it's meager even when nominally present. At this writing, fully 77% of outstanding leveraged loans are denoted "covenant lite," up from 17% in 2007. There's no settled definition of cov-lite, only that key maintenance covenants (e.g., debt to EBITDA) are missing.

Credit quality, too, is on the wane, as it tends to be at the end of long business expansions, let alone of expansions nurtured by radical monetary policy. Fully 45% of second-quarter issuance was rated in the neighborhood of single-B, up from 38% in 2017—and only 28% in 2006. Come the next default cycle, Moody's Investors Service projects, recovery rates on first-lien secured loans will drop to 60%, from an average of 77% between 2007 and 2016.

Leveraged loans pay in the neighborhood of Libor plus 300 to 350 basis points—so 5.3% to 5.8%. Managements pay dividends gladly, interest grudgingly and, seemingly, only after counsel has exhausted every possible avenue of escape. Loan covenants are put in place to protect the creditors from the predations of the borrowers. The fine print discourages the borrower from, among other things,

- piling on new debt;
- diverting or removing collateral;

**Quality-lite, too**




source: LCD, an offering of S&P Global Market Intelligence

• prepaying noncurrent, unsecured debt ahead of secured lenders;

• issuing additional first-lien debt equal in seniority to (pari passu with) the lender's claims;

• paying imprudently large dividends;

• channeling the proceeds of asset sales to dividend payments rather than to the repayment of debt.

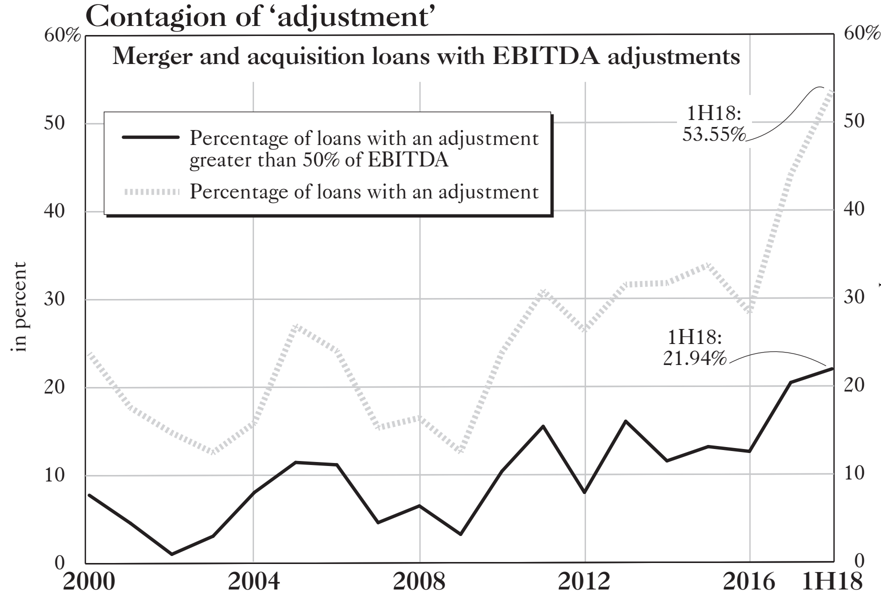
There's another side to the pancake, of course. You hear the loan bulls say that they invest in good companies only, that they don't bother with forecasts of recovery rates, that the covenant question is too complex a subject for journalistic discussion and that, according to none other than Moody's, forecast recovery rates are virtually identical between cov-lite and cov-heavy borrowers (which the agency does, in fact, predict). Besides, the bullish retort continues, cov-lite loans actually yield an average of 69 basis points less than the cov-heavy alternative. Better a strong credit with minimal contractual protection than a weak credit with maximum contractual protection, goes the rationale. That bit of sophistry eludes us and Sherman, too, who tells colleague Fabiano Santin, "It's sort of like a prenup. You don't really think you're going to need it, but it's always nice to have it. The problem with investing in covenant-lite loans is that you may not need [covenants] today, but you may need them in the future and you're going to really wish you had that prenup in place." So says the happily married, prenup-less credit investor.

Once upon a time, banks not only originated leveraged loans but also held them on balance sheet. Old-timers will recall the blight of "pier loans" in 1989–90. Credit intended to bridge the gap between the closing of a leveraged buyout and the funding of the associated long-term debt instead came to look permanent when the junk-bond market collapsed. Hence, the bridge loans became pier loans—bridges to nowhere.

Now the banks originate in order to syndicate. Foremost among the ultimate holders are the structures called collateralized loan obligations, which own 65% of the leveraged loans outstanding, and loan mutual funds, which hold 23%. (More on these entities in a coming issue of *Grant's*.)

"Bankers are free to be aggressive in the originating role," comments Santin, "since the new lenders are considered

**Contagion of 'adjustment'**




source: LCD, an offering of S&P Global Market Intelligence

sophisticated investors fit to do their own homework—save for fraudulent behavior by the bankers, of course.

"Aggressiveness takes the form of weak lending terms," Santin goes on. "Since the banks and their lawyers owe no long-term fiduciary duty to the ultimate creditors, they compete for mandates in the financing of mergers and acquisitions, leveraged buyouts, refinancing of secured loans (often just a few months after their issuance and years prior to their maturity) at ever lower credit spreads."

Cov-lite is only one feature of the not-so-new normal in secured debt. The flimsy protections afforded by seemingly cov-heavy contractual language is another. A 2015 Moody's report, "The Cov-Lite Label Can Mischaracterize Credit Risk," warned against credit agreements that protect the lender in name, the borrower (and its beloved shareholders) in fact. An example would be the stipulation of a seemingly safe ratio of cash flow to interest expense. It is safe until you delve into the borrower's definition of cash flow.

Every trainee knows that EBITDA is a slack, unrigorous, popular, non-GAAP measure of cash flow. It's defined as earnings before interest, taxes, depreciation and amortization. It can be—and commonly is—redefined by corporate managements, and this "adjusted" EBITDA is even slacker, less rigorous and more popular than the already debased EBITDA. (EBIT is the preferred, old-school cash-flow metric.) So Moody's sounded the alarm on "aggressive EBITDA add-backs."

What might be an example of the type? Valeant Pharmaceuticals International, Inc. (of which more below) obliges with a beauty. In calculating EBITDA, our old friend adds back "pro forma 'run rate' cost savings"—the money that the company expects to save through its hallmark dexterous management. So Valeant's EBITDA is actually EBITDAH: earnings before interest, taxes, depreciation, amortization and a hunch. S&P's LCD division reports that a record 22% of M&A-related loans issued in the first half of 2018 contained add-backs to adjusted EBITDA greater than 50% of EBITDA, double the 11.3% of such loans issued in 2005, which was the pre-2008 high.

Congressional apportioners of blame in the wake of our anticipated 2019 credit event will discover that the corruption of senior corporate debt began many years ago. A crystallizing case involves J. Crew Group, Inc.'s $1.5 billion first-lien, secured-term loan issued in 2014. Investors in that ill-begotten credit have nobly served as guinea pigs in Wall Street's investment-banking laboratory for compensation of just 300 basis points over three-month Libor.

The J. Crew loan, rated single-B before its demotion to triple-C, changes hands at 84 cents on the dollar, up from a 2017 low of 51 cents. By the lights of Bloomberg, L.P., the J. Crew credit is actually not cov-lite. Nor is it cov-heavy. Certainly, it is cov-deficient. It has, as Santin notes, "a certain key leverage-maintenance covenant that becomes effective only on November 2019 and allows for, yes, up to 15 times debt to EBITDA—the company's current leverage stands at 8 times."

"Secured," too, is a word open to interpretation in the EZ-money era. "The J. Crew Trapdoor" is the name affixed by credit-research firm Covenant Review, LLC to the retailer's transfer of intellectual property worth $250 million into a foreign subsidiary and out of the reach of the ostensibly secured creditors. To top it all, shortly after the switch, that subsidiary issued $250 million of 13% first-lien bonds due in 2021; the bonds were secured by the very same moveable IP. The subsidiary next offered an exchange to holders of its $560 million of subordinated payment-in-kind bonds due in 2019—the new 13% bonds for their heavily marked-down PIK notes. Assenting, the PIK holders allowed J. Crew to reduce its leverage by lopping off $310 million in subordinated unsecured debt. That improvement came out of the hide of the term-loan lenders, as their collateral was now someone else's.

There are winners as well as losers in the J. Crew switcheroo. The former PIK bondholders, who would have seen little recovery on their initial investment (they ranked last in the recovery line), are now in better shape than the term-loan lenders given their priority over the IP collateral. Reflecting this privileged position, the 13s of 2021 trade at 118 cents on the dollar. The bulk of J. Crew's $1.9 billion debt matures in 2021. Even with little or no cash generation, the company could bump along for three more years, zombie-fashion, further reducing the final recovery of the term-loan investors. In the past, observes Jessica Reiss, head of leveraged loan research at Covenant Review, secured lenders had the right to get involved at an earlier stage as leverage approached maintenance-covenant thresholds. The result was timelier bankruptcies, better recoveries—and fewer zombies. We commend this line of inquiry to future congressional staff.

"Like many a great invention, the J. Crew Trapdoor was the product of a great collaboration," observes Santin. "A year before J. Crew's move, Claire's Stores, Inc., under the private-equity ownership of Apollo Global Management, LLC, shifted trademark rights to a European subsidiary, and so became beyond the grasp of the secured creditors. The retailer was even then falling short of covering interest payments, and its leverage ran over 11 times adjusted EBITDA. It finally filed for bankruptcy this past March. Its first-lien secured notes trade at 64 cents. Creditors in trapdoor-prone instruments of other retailers are likewise behind the eight-ball: Revlon, Inc.'s term loan (whose 'trapdoor,' according to Brian Darsow, legal analyst at Debtwire, Inc., should probably be called a 'black hole,' given the issuer's ability to divert from secured creditors unlimited assets other than cash) trades at 77 cents."

So much for the known disasters. Split-rated Party City Holdings, Inc. (Ba3/double-B-plus) is an example of a prospective one, and we offer it, too, to the government's debt-investigating committee.

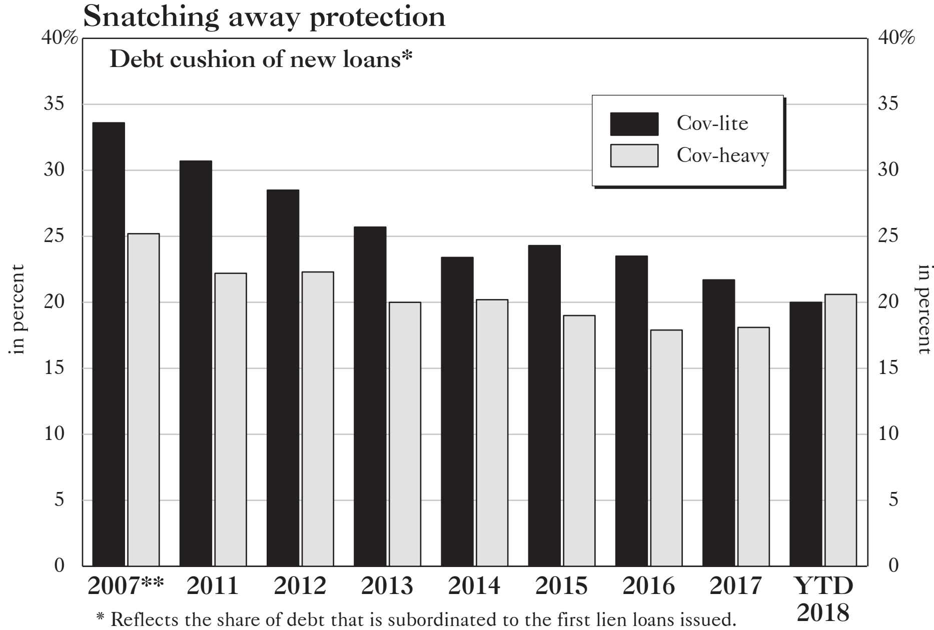
Party City's $1.2 billion first-lien secured loan, due August 2022, quoted at $100\frac{3}{8}$ cents and paying 275 basis points over Libor for a 5.07% current yield, is the asset to watch. The borrower is a listed subsidiary of the eponymous publicly listed vendor of balloons, string-pulled piñatas, sexy Halloween costumes, superhero Halloween costumes and personalized wedding tableware in which the funds managed by Thomas H. Lee Partners, L.P. own a 47% interest. Including $325 million in revolving bank debt and $350 million in $6\frac{1}{8}$% unsecured notes, debt totals $1.88 billion.

Party City is a creditworthy business. The question for the creditors is: How much and what kind of credit? Last year the company showed $2.37 billion in revenue and $280 million in operating income. Interest coverage, defined as operating income over interest expense, climbed to 3.2 times from 2.2 times in 2015, thanks to the retirement of debt from the proceeds of a 2015 IPO. Last year, management chose to apportion cash ($130 million net of $75 million for acquisitions) to the repurchase of stock.

EBITDA of $415 million for the trailing 12 months ended March 31 includes $40 million of add-ons. So adjusted, the ratio of debt to EBITDA stands at 4.5 times. The term loan and revolver—secured, first-lien credits—rank above the unsecured debt, while the term loan is effectively subordinated to the revolving facility.

Please bear with us, as the details not only tell the story but also describe the risks. The revolver has a senior priority lien over Party City's current assets—cash ($55 million), accounts receivables ($131 million) and inventory ($621 million). These represent the bulk of a retailer's tangible assets. The term loan has lien priority over long-term assets such as $300 million in property, plant and equipment and

**Snatching away protection**




* Reflects the share of debt that is subordinated to the first lien loans issued.
** There are not enough observations for the cov-lite sample in 2008–2010.
source: LCD, an offering of S&P Global Market Intelligence

$570 million allocated to trade names. At the end of 2017, the company's 747 stores operated under leases.

"A first lien it may be, and 'secured,' too," Santin notes, "but the $1.2 billion Party City loan lacks maintenance covenants, the language that limits new borrowing. Based on our estimates and a March 30 report by Ian Feng, legal analyst at Covenant Review, Party City could incur an additional $666 million in unsecured debt to take net leverage to 6 times based on its debt-ratio carveout. The company could then take leverage all the way to 7.3 times, based on what is known as the accordion feature in the credit agreement. (Accordion clauses do just what you'd expect they would—allow management to borrow beyond a predetermined limit.) Even at 7.3 times, there'd be room for another $315 million of unsecured borrowing, which could lift leverage to 8 times—assuming, of course, that the company could find lenders brave enough, bullish enough or uninformed enough to advance the funds."

There are potential traps in the Party City loan agreement. For instance, assuming that the company chose only to tap its secured debt capacity, it could borrow $605 million to pay dividends or repurchase shares, thereby boosting secured debt to 86% of its total debt, up from 81% today. That would be nothing out of the ordinary in this market, though it represents a loss of protection for senior lenders. In 2007, subordinated debt represented 35% of total debt among the cohort of leveraged corporate borrowers. It was a nice layer of insulation for the senior lenders. Today, that level of protection amounts to 22%, a less nice layer.

Besides, there are no covenants to prevent Party City from prepaying the 6 1/8s of 2023 ahead of the term loan that matures in 2022. The 6 1/8s trade at 100 1/8 cents for a 5.54% yield to worst on August 2020 when they are callable at par. While term-loan lenders benefit from rising rates (the current yield curve projects the loan to yield 5.47% to maturity), they are reciprocally exposed to the risk of falling ones. They are especially exposed to the risk of management deciding to pay down higher-yielding junior claims, loading more credit risk on the shoulders of the people who had thought they were free of it.

And Party City, too, has its trapdoor. According to Feng, the company could shuffle at least $410 million of collateral away from the secured lenders. As mentioned, the asset side of the balance sheet shows $300 million in machinery and equipment, leasehold improvements, furniture and fixtures plus $650 million in trade names and other such intellectual property. J. Crew showed just how mobile that IP can be.

Third and final exhibit is Valeant Pharmaceuticals's brand new $4.6 billion first-lien, secured-term loan due May 2025. The loan is rated double-B-minus; VRX itself, B3/single-B. The credit is the refinancing of a refinancing, all to the advantage of the scandal-plagued issuer. It's not just the American homeowner who owns a wonderful, free interest-rate option. Leveraged-loan borrowers do, too.

The new Valeant loan trades at par and pays 300 basis points over Libor for a 5.3% current yield. There's no Libor floor; if the benchmark money-market rate should fall to zero, Valeant's creditors would bear the full disappointment. The company owes an additional $5 billion in secured bonds and $15.6 billion in senior unsecured bonds, three quarters of which mature prior to the term loan. Total leverage stands at 6.8 times trailing adjusted EBITDA, marginally down from 7 times at the end of 2016.

Patent losses in branded products and price and volume pressure in the dermatology field have continued to harry the business. Goodwill impairment knocked first-quarter operating income for a $2.3 billion loss, compared to a positive $211 million in the like period of 2017. Adjusted EBITDA fell to $832 million from $861 million a year ago. However—*however*—first-quarter organic revenue showed 2% growth compared to a 4% drop in 2017. Reading the news, needy lenders flung their caps into the air, and the Valeant front office prepared to refi.

The result was the $4.6 billion loan, issued June 1. It refinanced a $3.8 billion term loan from November, which had refinanced a $3 billion term loan from the previous March. The company did better for itself each time it borrowed. The November loan was priced at 350 basis points over Libor, the March loan at 475 basis points over Libor. Since March 2017, Valeant has boosted indebtedness under its term loan by $1.6 billion. It has likewise issued $1.75 billion in secured bonds to prepay $6 billion in unsecured bonds. The latter, which contained some restrictive covenants, would have fallen due between 2020 and 2021. Of course, liquidation of unsecured debt throws more credit risk on the secured lenders as they carry a bigger portion of Valeant's business: Secured debt to estimated 2018 adjusted EBITDA stands at 3 times versus 2.48 times in 2015.

Not just in pricing has Valeant improved its position through these serial refinancings. The November loan agreement had tied management's hands by imposing a limit of 3 times secured debt to adjusted EBITDA. In dollar terms, that worked out to a maximum of $2.2 billion in additional secured borrowing, according to Dan Nicolich, senior covenant analyst at Reorg Research. By negotiating the June credit agreement and by refinancing the unsecured notes (the ones with the nettlesome covenants), Valeant has unlocked new borrowing capacity, as much as $4.1 billion in secured debt. Suffice it to say, observes Nicolich, that Valeant could, if it wished, under the new loan agreement, prioritize the repayment of the unsecured bondholders, so reducing the cushion of subordinated debt to protect the senior creditors.

Moreover, unlike the prior credit agreement that required the company to use proceeds from asset sales to prepay secured debt, the new loan allows management to use money from asset sales to make investments the creditors can't touch, according to Mark Xiong, legal analyst at Covenant Review.

We ask: Do the loan buyers realize it? Are they getting paid for it? These questions, too, we offer to the federal inquisitors of the future.

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