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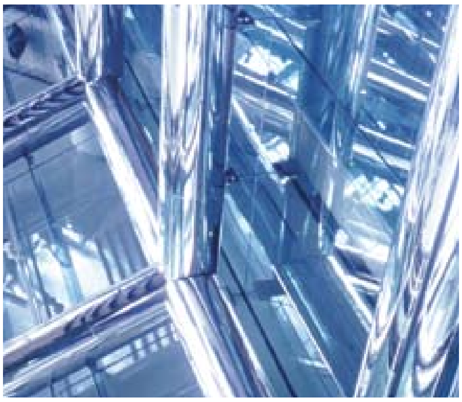
US v. European Loan Market: A Tale of Two Cities

Although now showing signs of cooling off, the US syndicated loan market has experienced in the opening months of 2011 a boom not seen since the heady days of the pre-crisis market. This note examines the key factors behind the recent resurgence of the US market, explores the different factors at work in the European market and examines the likelihood of the forces driving the US boom reaching across to Europe.



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US Loan Market

Pillars of the current US boom include:

- **The Ongoing Supply/Demand Imbalance:** The general scarcity of primary bank paper has left traditional loan market investors fighting for tickets. Liquidity has been lifted dramatically by the appearance of fixed income funds - attracted by the LIBOR floors now firmly embedded as a fixture in loan market deals - and the re-emergence of many of the banks and (to a lesser extent) CLO funds that exited the market in 2008. Investors are pouring money into floating rate corporate loans as a hedge against the widely anticipated rise in interest rates.
- **Economic Stability:** To the surprise of many, the experience of default on US syndicated loans has been mild despite the worst recession since the 1930s. Although the slashing of interest rates and the huge injection of cash into the financial system by the Federal Reserve undoubtedly saved the market from meltdown, the continuing prevalence of low borrowing costs fuels demand and exacerbates the feverish search for yield. Prior to the recent catastrophic events in Japan, investors had appeared undaunted by the effect of turmoil in North Africa and the Middle East on the price of oil, and the danger that higher fuel prices will translate into inflation, higher interest rates and a sharp increase in the number of corporate failures.
- **The Rise and Rise of High Yield:** The flight to junk bonds seen in 2010 (a trend which remains strong in the first quarter of 2011) has had a sobering effect on loan market investors. Although for borrowers and sponsors the lure of higher leverage is a key element of the recent spate of high yield issuances, the requirement to comply only with a set of incurrence covenants has certainly been an added draw, assisted to some extent by a perception that during the lean years of the crisis banks and other loan market investors took advantage of covenant resets to milk borrowers for fees and higher margins.
- **Increasing Flexibility:** A combination of the factors described above has driven loan market investors to accommodate the demands of crisis-scarred borrowers, resulting in a return to structures, terms and conditions last seen in 2006 and early 2007. In particular, the pressure on investors to entice borrowers away from the high yield market has resulted in an explosion of covenant-lite loans. According to analysts, more than 25% of first-lien loans issued in 2011 have covenant-lite structures. The competition is fierce: both the Del Monte and J Crew financings saw the covenant-lite loan element increase in

size during syndication, and Axcan Pharma reportedly dropped its proposed high yield deal altogether, opting instead for a covenant-lite term loan. In terms of risk, investors have been encouraged by the general observation that such loans not only fared no worse than regular loans during the crisis, but in fact saw slightly better returns. In terms of investment fit, the return of non-bank investors in the shape of fixed income funds invites comparison with the CLO goldrush of 2006-2007, considered by many to have been responsible for the late surge in covenant-lite loans during the last credit cycle (non-bank lenders generally being eager for higher yields than those supported by regular loans, as well as being too thinly resourced to handle amendment/waiver discussions, reluctant to receive potentially price-sensitive information and in any event insulated against risk through credit default swaps). Recent calls on the part of sponsors for so-called "naked revolvers" (i.e. revolving credit facilities without maintenance covenants, a feature not seen even at the height of the market) so far appear to have been roundly rejected (on the basis that, since few funds have the operational capacity to deal with frequent drawdowns and repayments, revolvers are still generally held by banks and therefore more tricky to syndicate). The idea of naked revolvers may not catch on – after all, borrowers in the US market already benefit from the availability of asset based lending (ABL) structures which offer (so long as excess availability remains above an agreed threshold) a covenant-lite approach. Nevertheless, the mere fact that sponsors have been calling for naked revolvers illustrates the extent to which the US loan market is moving in favour of borrowers.

European Loan Market

Can we expect to see the current US boom extend to Europe? The European loan market suffers from a similar lack of supply, but it has yet to see demand driven by liquidity on the scale of the US, not least as a result of regulatory restrictions on the eligibility of leveraged loans as an investment option for European collective investment funds, and since confusion over the interpretation of new EU legislation continues to stymie the re-emergence of European CLO funds. Nevertheless, recent oversubscriptions on deals including Vue Entertainment, Picard Surgeles, Britax and Mivisa (in the case of the latter, resulting in a rare 75bps reverse flex) demonstrate a healthy appetite for LBO debt. Moreover, the competition from high yield is no less harsh this side of the pond, with Ardagh Glass and Advent International preferring the junk bond market in connection with their recent respective acquisitions of Impress and Priory Group.

While in the European loan market the pressure on investors to kowtow to borrower demands is not yet as acute as in the US (and in particular, loan pricing has not fallen as sharply as in the US, where the search for yield in the face of lower margins is understood to be a significant factor in the rise of covenant-lite debt), the US$500 million covenant-lite deal announced by NXP Superconductors B.V. may prove the first of many. Indeed, rumours that this dollar-denominated issuance has been placed largely with US investors raises the tantalising prospect of an overspill of liquidity from the booming US market.

Nevertheless, despite showing healthy signs of life, the European market is unlikely to catch up with the current US boom in the near future. Even at the peak of the US market in 2007, which saw $100 billion of covenant-lite debt in the first six months of that year, covenant-lite barely made it off the ground in Europe. Many point to the difference in investor base, with 90% of US term debt held by non-bank investors at the height of the market, compared with just 50% in Europe. Whatever the cause, the relative lack of liquidity in Europe, combined with traditional restrictions on investment by US funds (whose typical eligibility criteria excludes investment in non-dollar denominated debt and sets strict concentration limits on the quantum of investment in non-US debt), puts the European loan market on a different road to recovery. A two-track race it may be, but the general reinvigoration of the US and European loan markets is to be welcomed, coming as it does after such an unprecedented crash, and no doubt some of the peak market terms currently seen in New York will attempt to make the swim across the Atlantic.

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