

**STANDARD  
& POOR'S**

# A Guide to the Loan Market

September 2006



STANDARD  
&POOR'S

# **A Guide To The Loan Market**

**September 2006**

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2006 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's, our parent, The McGraw-Hill Companies, and reputable third parties that may be of interest to them. All subscriber billing and contact data collected is stored in a secure database in the U.S. and access is limited to authorized persons. If you would prefer not to have your information used as outlined in this notice, if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 212-438-7280 or write us at: [privacy@standardandpoors.com](mailto:privacy@standardandpoors.com). For more information about The McGraw-Hill Companies Privacy Policy please visit [www.mcgraw-hill.com/privacy.html](http://www.mcgraw-hill.com/privacy.html).

Analytic services provided by Standard & Poor's Ratings Services ("Ratings Services") are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees). Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-9823; or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).

## To Our Clients

Standard & Poor's Ratings Services is pleased to bring you the 2006-2007 edition of our Guide to the Loan Market, which provides a detailed primer on the syndicated loan market (with new sections that discuss loan credit default swaps, covenant-lite loans, and public/private issues), along with articles that describe the bank loan and recovery rating process as well as our analytical approach to evaluating loss and recovery in the event of default.

Throughout the past decade, we have been privileged to be part of the evolution of the leveraged loan market from traditional relationship lending to its current position as a fully developed asset class within the capital markets. As part of that market development, loan ratings have become a staple of the leveraged loan market and are now assigned to about three-quarters of newly issued loans.

In 2003, Standard & Poor's introduced a new rating—the Recovery Rating—to complement its traditional loan rating. Whereas the loan rating, since its introduction in 1995, has always incorporated the likelihood of loss and recovery along with its evaluation of the likelihood of default, the recovery rating focuses exclusively on loss and recovery prospects in the event of default. We expect that it will, along with our traditional ratings, fill the need that banks and investors have for separate, distinct, and fully transparent measures of both the likelihood of default and the likely loss/recovery in the event of default.

We now assign recovery ratings to all secured loans that we rate, along with our traditional loan rating. As of press time, Standard & Poor's has assigned recovery ratings to the loans of more than 1,500 companies since introducing the rating in 2003. We also produce detailed recovery rating reports on most of them, which are available to syndicators and investors. (To request a copy of a report on a specific loan and recovery rating, please refer to the contact information below.)

Although loan rating forms the core of Standard & Poor's commitment to the loan market, our involvement goes much deeper. In addition to rating loans, we offer a wide range of other services for loan market participants, including:

- **Data and commentary:** Standard & Poor's Leveraged Commentary and Data (LCD) unit is the leading provider of real-time news, statistical reports, market commentary, and data for leveraged loan and high-yield market participants.
- **Loan price evaluations:** Standard & Poor's Evaluation Service provides price evaluations for leveraged loan investors.
- **Recovery statistics:** Standard & Poor's LossStats™ database is the industry standard for recovery information for bank loans and other debt classes.

If you want to learn more about our loan market services, all the appropriate contact information is listed in the back of this publication. We welcome questions, suggestions, and feedback of all kinds on our products and services, and on this Guide, which we plan to update annually. We publish a free weekly update, by e-mail, of all the loan ratings that we issue. To be put on the subscription list to receive that, or to obtain a PDF version of this report, please e-mail your name and contact information to [steven\\_bavaria@standardandpoors.com](mailto:steven_bavaria@standardandpoors.com). You can also access that report and many other articles, including this entire Guide to the Loan Market in electronic form, on our Standard & Poor's loan and recovery rating website: [www.bankloanrating.standardandpoors.com](http://www.bankloanrating.standardandpoors.com).



Steven Miller



Steven Bavaria



# Contents

To Our Clients	3
A Syndicated Loan Primer	7
Rating Secured Loans: An Overview	26
Methodology For U.S. Recovery Ratings	31
Second-Lien Pricing May Not Fully Recognize Risk Of Loss Given Default	37
Loan Market Services Directory	51



# A Syndicated Loan Primer

Steven Miller  
New York (1) 212-438-2715

A syndicated loan is one that is provided by a group of lenders and is structured, arranged, and administered by one or several commercial or investment banks known as arrangers.

Starting with the large leveraged buyout (LBO) loans of the mid-1980s, the syndicated loan market has become the dominant way for issuers to tap banks and other institutional capital providers for loans. The reason is simple: Syndicated loans are less expensive and more efficient to administer than traditional bilateral, or individual, credit lines.

At the most basic level, arrangers serve the time-honored investment-banking role of raising investor dollars for an issuer in need of capital. The issuer pays the arranger a fee for this service, and, naturally, this fee increases with the complexity and riskiness of the loan. As a result, the most profitable loans are those to leveraged borrowers—issuers whose credit ratings are speculative grade and who are paying spreads (premiums above LIBOR or another base rate) sufficient to attract the interest of nonbank term loan investors, typically LIBOR+200 or higher, though this threshold moves up and down depending on market conditions.

Indeed, large, high-quality companies pay little or no fee for a plain-vanilla loan, typically an unsecured revolving credit instrument that is used to provide support for short-term commercial paper borrowings or for working capital. In many cases, moreover,

these borrowers will effectively syndicate a loan themselves, using the arranger simply to craft documents and administer the process. For leveraged issuers, the story is a very different one for the arranger, and, by “different,” we mean much more lucrative. A new leveraged loan can carry an arranger fee of up to 2.5% of the total loan commitment, depending on the complexity of the transaction. Merger and acquisition (M&A) and recapitalization loans will likely carry high fees, as will exit financings and restructuring deals. Seasoned leveraged issuers, by contrast, pay radically lower fees for refinancings and add-on transactions.

Because investment-grade loans are infrequently used and, therefore, offer drastically lower yields, the ancillary business is as important a factor as the credit product in arranging such deals, especially because many acquisition-related financings for investment-

grade companies are large in relation to the pool of potential investors, which would consist solely of banks.

The “retail” market for a syndicated loan consists of banks and, in the case of leveraged transactions, finance companies and institutional investors. Before formally launching a loan to these retail accounts, arrangers will often get a market read by informally polling select investors to gauge their appetite for the credit. Based on these discussions, the arranger will launch the credit at a spread and fee it believes will clear the market. After this market read, the arrangers will launch the deal at a spread and fee that it thinks will clear the market. Until 1998, this would have been it. Once the pricing was set, it was set, except in the most extreme cases. If the loan were undersubscribed, the arrangers could very well be left above their desired hold level. Since the Russian debt crisis roiled the market in 1998, however, arrangers have adopted market-flex language, which allows them to change the pricing of the loan based on investor demand—in some cases within a predetermined range—as well as shift amounts between various tranches of a loan, as a standard feature of loan commitment letters. Market-flex language, in a single stroke, pushed the loan market, at least the leveraged segment of it, across the Rubicon, to a full-fledged capital market.

Initially, arrangers invoked flex language to make loans more attractive to investors by hiking the spread or lowering the price. This was logical after the volatility introduced by the Russian debt debacle. Over time, however, market-flex became a tool either to increase or decrease pricing of a loan, based on investor reaction.

As a result of market flex, a loan syndication today functions as a “book-building” exercise, in bond-market parlance. A loan is originally launched to market at a target spread or, as was increasingly common by 2006, with a range of spreads referred to as price talk (i.e., a target spread of, say, LIBOR+250 to LIBOR+275). Investors then will make commitments that in many cases are tiered by the spread. For example, an account may put in for \$25 million at

LIBOR+275 or \$15 million at LIBOR+250. At the end of the process, the arranger will total up the commitments and then make a call on where to price the paper. Following the example above, if the paper is vastly oversubscribed at LIBOR+250, the arranger may slice the spread further. Conversely, if it is undersubscribed even at LIBOR+275, then the arranger will be forced to raise the spread to bring more money to the table.

## Types Of Syndications

There are three types of syndications: an underwritten deal, a “best-efforts” syndication, and a “club deal.”

### Underwritten deal

An underwritten deal is one for which the arrangers guarantee the entire commitment, then syndicate the loan. If the arrangers cannot fully subscribe the loan, they are forced to absorb the difference, which they may later try to sell to investors. This is easy, of course, if market conditions, or the credit’s fundamentals, improve. If not, the arranger may be forced to sell at a discount and, potentially, even take a loss on the paper. Or the arranger may just be left above its desired hold level of the credit. So, why do arrangers underwrite loans? First, offering an underwritten loan can be a competitive tool to win mandates. Second, underwritten loans usually require more lucrative fees because the agent is on the hook if potential lenders balk. Of course, with flex-language now common, underwriting a deal does not carry the same risk it once did when the pricing was set in stone prior to syndication.

### Best-efforts syndication

A “best-efforts” syndication is one for which the arranger group commits to underwrite less than the entire amount of the loan, leaving the credit to the vicissitudes of the market. If the loan is undersubscribed, the credit may not close—or may need major surgery to clear the market. Traditionally, best-efforts syndications were used for risky borrowers or for complex transactions. Since the late 1990s, however, the rapid acceptance of market-flex

language has made best-efforts loans the rule even for investment-grade transactions.

#### **Club deal**

A “club deal” is a smaller loan (usually \$25 million to \$100 million, but as high as \$150 million) that is premarketed to a group of relationship lenders. The arranger is generally a first among equals, and each lender gets a full cut, or nearly a full cut, of the fees.

### **The Syndication Process**

#### **The information memo, or “bank book”**

Before awarding a mandate, an issuer might solicit bids from arrangers. The banks will outline their syndication strategy and qualifications, as well as their view on the way the loan will price in market. Once the mandate is awarded, the syndication process starts. The arranger will prepare an information memo (IM) describing the terms of the transactions. The IM typically will include an executive summary, investment considerations, a list of terms and conditions, an industry overview, and a financial model. Because loans are not securities, this will be a confidential offering made only to qualified banks and accredited investors. If the issuer is speculative grade and seeking capital from nonbank investors, the arranger will often prepare a “public” version of the IM. This version will be stripped of all confidential material such as management financial projections so that it can be viewed by accounts that operate on the public side of the wall or that want to preserve their ability to buy bonds or stock or other public securities of the particular issuer (*see the Public Versus Private section on page 10*). Naturally, investors that view materially nonpublic information of a company are disqualified from buying the company’s public securities for some period of time.

As the IM (or “bank book,” in traditional market lingo) is being prepared, the syndicate desk will solicit informal feedback from potential investors on what their appetite for the deal will be and at what price they are willing to invest. Once this intelligence has been gathered, the agent will formally market the deal to potential investors.

The executive summary will include a description of the issuer, an overview of the transaction and rationale, sources and uses, and key statistics on the financials.

*Investment considerations* will be, basically, management’s sales “pitch” for the deal.

*The list of terms and conditions* will be a preliminary term sheet describing the pricing, structure, collateral, covenants, and other terms of the credit (covenants are usually negotiated in detail after the arranger receives investor feedback).

*The industry overview* will be a description of the company’s industry and competitive position relative to its industry peers.

*The financial model* will be a detailed model of the issuer’s historical, pro forma, and projected financials including management’s high, low, and base case for the issuer.

Most new acquisition-related loans are kicked off at a bank meeting at which potential lenders hear management and the sponsor group (if there is one) describe what the terms of the loan are and what transaction it backs. Management will provide its vision for the transaction and, most important, tell why and how the lenders will be repaid on or ahead of schedule. In addition, investors will be briefed regarding the multiple exit strategies, including second ways out via asset sales. (If it is a small deal or a refinancing instead of a formal meeting, there may be a series of calls or one-on-one meetings with potential investors.)

Once the loan is closed, the final terms are then documented in detailed credit and security agreements. Subsequently, liens are perfected and collateral is attached.

Loans, by their nature, are flexible documents that can be revised and amended from time to time. These amendments require different levels of approval (*see Voting Rights section*). Amendments can range from something as simple as a covenant waiver to something as complex as a change in the collateral package or allowing the issuer to stretch out its payments or make an acquisition.

#### **The loan investor market**

There are three primary-investor consistencies: banks, finance companies, and institutional investors.

*Banks*, in this case, can be either a commercial bank, a savings and loan institution, or a securities firm that usually provides investment-grade loans. These are typically large revolving credits that back commercial paper or general corporate purposes or, in some cases, acquisitions. For leveraged loans, banks typically provide unfunded revolving credits, LOCs, and—although they are becoming increasingly less common—amortizing term loans, under a syndicated loan agreement.

*Finance companies* have consistently represented less than 10% of the leveraged loan market, and tend to play in smaller deals—\$25 million to \$200 million. These investors often seek asset-based loans that carry wide spreads and that often feature time-intensive collateral monitoring.

*Institutional investors* in the loan market are principally structured vehicles known as collateralized loan obligations (CLO) and loan participation mutual funds (known as “prime funds” because they were originally pitched to investors as a money-market-like fund that would approximate the prime rate). In addition, hedge funds, high-yield bond funds, pension funds, insurance companies, and other proprietary investors do participate opportunistically in loans. Typically, however, they invest principally in wide-margin loans (referred to by some players as “high-octane” loans), with spreads of LIBOR+500 or higher. During the first half of 2006, these players accounted for roughly 20% of overall investment.

CLOs are special-purpose vehicles set up to hold and manage pools of leveraged loans. The special-purpose vehicle is financed with several tranches of debt (typically a ‘AAA’ rated tranche, a ‘AA’ tranche, a ‘BBB’ tranche, and a mezzanine tranche) that have rights to the collateral and payment stream in descending order. In addition, there is an equity tranche, but the equity tranche is usually not rated. CLOs are created as arbitrage vehicles that generate equity returns through leverage, by issuing debt 10 to 11 times their equity contribution. There are also market-value CLOs that are less leveraged—typically 3 to 5 times—and allow managers more flexibility than more tightly structured arbitrage

deals. CLOs are usually rated by two of the three major ratings agencies and impose a series of covenant tests on collateral managers, including minimum rating, industry diversification, and maximum default basket. By 2006, CLOs had become the dominant form of institutional investment in the leveraged loan market, taking a commanding 60% of primary activity by institutional investors.

*Prime funds* are how retail investors can access the loan market. They are mutual funds that invest in leveraged loans. Prime funds were first introduced in the late 1980s. Most of the original prime funds were continuously offered funds with quarterly tender periods. Managers then rolled true closed-end, exchange-traded funds in the early 1990s. It was not until the early 2000s that fund complexes introduced open-ended funds that were redeemable each day. While quarterly redemption funds and closed-end funds remained the standard because the secondary loan market does not offer the rich liquidity that is supportive of open-end funds, the open-end funds had sufficiently raised their profile that by mid-2006 they accounted for 15% to 20% of the loan assets held by mutual funds.

### Public Versus Private

In the old days, the line between public and private information in the loan market was a simple one. Loans were strictly on the private side of the wall and any information transmitted between the issuer and the lender group remained confidential.

In the late 1980s, that line began to blur as a result of two market innovations. The first was more active secondary trading that sprung up to support (1) the entry of non-bank investors in the market, such as insurance companies and loan mutual funds and (2) to help banks sell rapidly expanding portfolios of distressed and highly leveraged loans that they no longer wanted to hold. This meant that parties that were insiders on loans might now exchange confidential information with traders and potential investors who were not (or not yet) a party to the loan. The second innovation that weakened the public-pri-

vate divide was trade journalism that focuses on the loan market.

Despite these two factors, the public versus private line was well understood and rarely controversial for at least a decade. This changed in the early 2000s as a result of:

- The explosive growth of nonbank investors groups, which included a growing number of institutions that operated on the public side of the wall, including a growing number of mutual funds, hedge funds, and even CLO boutiques;
- The growth of the credit default swaps market, in which insiders like banks often sold or bought protection from institutions that were not privy to inside information, and
- A more aggressive effort by the press to report on the loan market.

Some background is in order. The vast majority of loans are unambiguously private financing arrangements between issuers and their lenders. Even for issuers with public equity or debt that file with the SEC, the credit agreement only becomes public when it is filed, often long after closing, as an exhibit to an annual report (10-K), a quarterly report (10-Q), a current report (8-K), or some other document (proxy statement, securities registration, etc.).

Beyond the credit agreement, there is a raft of ongoing correspondence between issuers and lenders that is made under confidentiality agreements, including quarterly or monthly financial disclosures, covenant compliance information, amendment and waiver requests, and financial projections, as well as plans for acquisitions or dispositions. Much of this information may be material to the financial health of the issuer and may be out of the public domain until the issuer formally puts out a press release or files an 8-K or some other document with the SEC.

In recent years, this information has leaked into the public domain either via off-line conversations or the press. It has also come to light through mark-to-market pricing services, which often report significant movement in a loan price without any corresponding news. This is usually an indication that the banks have received negative or positive information that is not yet public.

By 2006, there was growing concern among issuers, lenders, and regulators that this migration of once private information into public hands might breach confidentiality agreements between lenders and issuers and, more importantly, could lead to illegal trading. How has the market contended with these issues?

- Traders. To insulate themselves from violating regulations, some dealers and buy-side firms have set up their trading desks on the public side of the wall. Consequently, traders, salespeople, and analysts do not receive private information even if somewhere else in the institution the private data are available. This is the same technique that investment banks have used from time immemorial to separate their private investment banking activities from their public trading and sales activities.
- Underwriters. As mentioned above, in most primary syndications, arrangers will prepare a public version of information memoranda that is scrubbed of private information like projections. These IMs will be distributed to accounts that are on the public side of the wall. As well, underwriters will ask public accounts to attend a public version of the bank meeting and distribute to these accounts only scrubbed financial information.
- Buy-side accounts. On the buy-side there are firms that operate on either side of the public-private fence. Accounts that operate on the private side receive all confidential materials and agree to not trade in public securities of the issuers for which they get private information. These groups are often part of wider investment complexes that do have public funds and portfolios but, via Chinese walls, are sealed from these parts of the firms. There are also accounts that are public. These firms take only public IMs and public materials and, therefore, retain the option to trade in the public securities markets even when an issuer for which they own a loan is involved. This can be tricky to pull off in practice because in the case of an amendment the lender could be called on to approve or decline in the absence of any

real information. To contend with this issue, the account could either designate one person who is on the private side of the wall to sign off on amendments or empower its trustee or the loan arranger to do so. But it's a complex proposition.

- **Vendors.** Vendors of loan data, news, and prices also face many challenges in managing the flow of public and private information. In general, the vendors operate under the freedom of the press provision of the U.S. Constitution's First Amendment and report on information in a way that anyone can simultaneously receive it—for a price of course. Therefore, the information is essentially made public in a way that doesn't deliberately disadvantage any party, whether it's a news story discussing the progress of an amendment or an acquisition, or it's a price change reported by a mark-to-market service. This, of course, doesn't deal with the underlying issue that someone who is a party to confidential information is making it available via the press or prices to a broader audience.

Another way in which participants deal with the public versus private issue is to ask counterparties to sign “big-boy” letters acknowledging that there may be information they are not privy to and they are agreeing to make the trade in any case. They are, effectively, big boys and will accept the risks.

The introduction of loan credit default swaps into the fray (see below) adds another wrinkle to this topic because a whole new group of public investors could come into play if that market catches fire.

### Credit Risk: An Overview

Pricing a loan requires arrangers to evaluate the risk inherent in a loan and to gauge investor appetite for that risk. The principal credit risk factors that banks and institutional investors contend with in buying loans are default risk and loss-given-default risk. Among the primary ways that accounts judge these risks are ratings, credit statistics, industry sector trends, management strength, and sponsor. All of these, together, tell a story about the deal.

Brief descriptions of the major risk factors follow.

#### Default risk

Default risk is simply the likelihood of a borrower's being unable to pay interest or principal on time. It is based on the issuer's financial condition, industry segment, and conditions in that industry and economic variables and intangibles, such as company management. Default risk will, in most cases, be most visibly expressed by a public rating from Standard & Poor's Ratings Services or another ratings agency. These ratings range from 'AAA' for the most creditworthy loans to 'CCC' for the least. The market is divided, roughly, into two segments: investment grade (loans rated 'BBB-' or higher) and leveraged (borrowers rated 'BB+' or lower). Default risk, of course, varies widely within each of these broad segments. Since the mid-1990s, public loan ratings have become a de facto requirement for issuers that wish to tap the leveraged loan market, which, as noted above, is now dominated by institutional investors. Unlike banks, which typically have large credit departments and adhere to internal rating scales, fund managers rely on agency ratings to bracket risk and explain the overall risk of their portfolios to their own investors. As of mid-2006, then, roughly three-quarters of leveraged-loan volume carried a loan rating, up from 45% in 1998 and virtually none before 1995.

#### Loss-given-default risk

Loss-given-default risk measure how severe a loss the lender would incur in the event of default. Investors assess this risk based on the collateral (if any) backing the loan and the amount of other debt and equity subordinated to the loan. Lenders will also look to covenants to provide a way of coming back to the table early—that is, before other creditors—and renegotiating the terms of a loan if the issuer fails to meet financial targets. Investment-grade loans are, in most cases, senior unsecured instruments with loosely drawn covenants that apply only at incurrence, that is, only if an

issuer makes an acquisition or issues debt. As a result, loss given default may be no different from risk incurred by other senior unsecured creditors. Leveraged loans, by contrast, are, in virtually all cases, senior secured instruments with tightly drawn maintenance covenants, that is, covenants that are measured at the end of each quarter whether or not the issuer takes any action. Loan holders, therefore, almost always are first in line among pre-petition creditors and, in many cases are able to renegotiate with the issuer before the loan becomes severely impaired. It is no surprise, then, that loan investors historically fare much better than other creditors on a loss-given-default basis.

### **Credit statistics**

Credit statistics are used by investors to help calibrate both default and loss-given-default risk. These statistics include a broad array of financial data, including credit ratios measuring leverage (debt to capitalization and debt to EBITDA) and coverage (EBITDA to interest, EBITDA to debt service, operating cash flow to fixed charges). Of course, the ratios investors use to judge credit risk vary by industry. In addition to looking at trailing and pro forma ratios, investors look at management's projections and the assumptions behind these projections to see if the issuer's game plan will allow it to pay its debt comfortably. There are ratios that are most geared to assessing default risk. These include leverage and coverage. Then there are ratios that are suited for evaluating loss-given-default risk. These include collateral coverage, or the value of the collateral underlying the loan relative to the size of the loan. Also, the ratio of senior secured loan to junior debt in the capital structure. Logically, the likely severity of loss-given-default for a loan increases with the size of the loan as a percentage of the overall debt structure so does. After all, if an issuer defaults on \$100 million of debt, of which \$10 million is in the form of senior secured loans, the loans are more likely to be fully covered in bankruptcy than if the loan totals \$90 million.

### **Industry sector**

Industry is a factor, because sectors, naturally, go in and out of favor. For that reason, having a loan in a desirable sector, like telecom in the late 1990s or healthcare in the early 2000s, can really help a syndication along. Also, defensive loans (like consumer products) can be more appealing in a time of economic uncertainty, whereas cyclical borrowers (like chemicals or autos) can be more appealing during an economic upswing.

### **Sponsorship**

Sponsorship is a factor too. Needless to say, many leveraged companies are owned by one or more private equity firms. These entities, such as Kohlberg Kravis & Roberts or Carlyle Group, invest in companies that have leveraged capital structures. To the extent that the sponsor group has a strong following among loan investors, a loan will be easier to syndicate and, therefore, can be priced lower. In contrast, if the sponsor group does not have a loyal set of relationship lenders, the deal may need to be priced higher to clear the market. Among banks, investment factors may include whether or not the bank is party to the sponsor's equity fund. Among institutional investors, weighting is given to an individual deal sponsor's track record in fixing its own impaired deals by stepping up with additional equity or replacing a management team that is failing.

### **Syndicating A Loan By Facility**

Most loans are structured and syndicated to accommodate the two primary syndicated lender constituencies: banks (domestic and foreign) and institutional investors (primarily structured finance vehicles, mutual funds, and insurance companies). As such, leveraged loans consist of:

- Pro rata debt consists of the revolving credit and amortizing term loan (TLA), which are packaged together and, usually, syndicated to banks. In some loans, however, institutional investors take pieces of the TLA and, less often, the revolving credit, as a way to secure a larger institutional term loan allo-

cation. Why are these tranches called “pro rata?” Because arrangers historically syndicated revolving credit and TLa’s on a pro rata basis to banks and finance companies.

- Institutional debt consists of term loans structured specifically for institutional investors, although there are also some banks that buy institutional term loans. These tranches include first- and second-lien loans, as well as prefunded letters of credit. Traditionally, institutional tranches were referred to as TLbs because they were bullet payments and lined up behind TLAs. Finance companies also play in the leveraged loan market, and buy both pro rata and institutional tranches. With institutional investors playing an ever-larger role, however, by 2006 many executions were structured as simply revolving credit/institutional term loans, with the TLa falling by the wayside.

### Pricing A Loan In The Primary Market

Pricing loans for the institutional market is a straightforward exercise based on simple risk/return consideration and market technicals. Pricing a loan for the bank market, however, is more complex. Indeed, banks often invest in loans for more than pure spread income. Rather, banks are driven by the overall profitability of the issuer relationship, including noncredit revenue sources.

#### Pricing loans for bank investors

Since the early 1990s, almost all large commercial banks have adopted portfolio-management techniques that measure the returns of loans and other credit products relative to risk. By doing so, banks have learned that loans are rarely compelling investments on a stand-alone basis. Therefore, banks are reluctant to allocate capital to issuers unless the total relationship generates attractive returns—whether those returns are measured by risk-adjusted return on capital, by return on economic capital, or by some other metric.

If a bank is going to put a loan on its balance sheet, then it takes a hard look not only at the loan’s pricing, but also at other sources of revenue from the relationship, including noncredit

businesses—like cash-management services and pension-fund management—and economics from other capital markets activities, like bonds, equities, or M&A advisory work.

This process has had a breathtaking result on the leveraged loan market—to the point that it is an anachronism to continue to call it a “bank” loan market. Indeed, the number of banks that play actively (banks that made 10 or more retail commitments over an annual period) as retail investors in the leveraged loan market has withered from 110 in 1999 to roughly 70 by 2006. (We define this as banks that made 10 or more retail commitments over an annual period.) However, this is up from the low periods of 2001 and 2002 when just 35 banks were actively involved in the leveraged loan market. Even those banks that were still active had trimmed their commitments to leveraged loans significantly. As a result, the amount of capital from banks available to leveraged issuers has shriveled from the all-time peak of \$13 billion raised for Kohlberg Kravis Roberts’s 1989 LBO) of RJR Nabisco to roughly \$5 billion by 2006 for the strongest ‘BB+’ name. Of course, there are certain issuers that can generate a bit more; as of mid-2006, these include issuers with a European or even a Midwestern U.S. angle. Naturally, issuers with European operations are able to better tap banks in their home markets (banks still provide the lion’s share of loans in Europe), and, for Midwestern issuers, the heartland remains one of the few U.S. regions with a deep bench of local banks.

What this means is that the spread offered to pro rata investors is important, but even more important, in most cases, is the amount of other, fee-driven business a bank can capture by taking a piece of a loan. For this reason, issuers are careful to award pieces of bond- and equity-underwriting engagements and other fee-generating business to banks that are part of its loan syndicate.

### Pricing Loans For Institutional Players

For institutional investors, the investment decision process is far more straightforward,

because, as mentioned above, they are focused not on a basket of revenue, but only on loan-specific revenue.

In pricing loans to institutional investors, it's a matter of the spread of the loan relative to credit quality and market-based factors. This second category can be divided into liquidity and market technicals (i.e., supply/demand).

*Liquidity* is the tricky part, but, as in all markets, all else being equal, more liquid instruments command thinner spreads than less liquid ones. In the old day—before institutional investors were the dominant investors and banks were less focused on portfolio management—the size of a loan didn't much matter. Loans sat on the books of banks and stayed there. But now that institutional investors and banks put a premium on the ability to package loans and sell them, liquidity has become important. As a result, smaller executions—generally those of \$200 million or less—tend to be priced at a premium to the larger loans. Those in the middle, \$200 million to \$2 billion, were, through 2006 at least, the market's "sweet spot," within investor capacity and sizable enough to generate secondary interest. Those exceeding \$2 billion would often command a spread premium to compensate investors for stepping up for larger pieces. These numbers represent a rough guide, although they do, naturally, move around, depending on the supply/demand dynamics of the market.

*Market technicals, or supply relative to demand*, is a matter of simple economics. If there are a lot of dollars chasing little product, then, naturally, issuers will be able to command lower spreads. If, however, the opposite is true, then spreads will need to increase for loans to clear the market.

### Mark-To-Market's Effect

Beginning in 2000, the SEC directed bank loan mutual fund managers to use available mark-to-market data (bid/ask levels reported by secondary traders and compiled by mark-to-market services like Markit Loans) rather than fair value (estimated prices), to determine the value of broadly syndicated loans for portfolio-valuation purposes. In broad

terms, this policy has made the market more transparent, improved price discovery and, in doing so, made the market far more efficient and dynamic than it was in the past. In the primary market, for instance, leveraged loan spreads are now determined not only by rating and leverage profile, but also by trading levels of an issuer's previous loans and, often, bonds. Issuers and investors can also look at the trading levels of comparable loans for market-clearing levels. What's more, and market sentiment tied to supply and demand. As a result, new-issue spreads rise and fall far more rapidly than in the past, when spreads were more or less the same for every leveraged transaction.

### Types Of Syndicated Loan Facilities

There are four main types of syndicated loan facilities:

- A revolving credit (within which are options for swingline loans, multicurrency-borrowing, competitive-bid options, term-out, and evergreen extensions);
- A term loan;
- An LOC; and
- An acquisition or equipment line (a delayed-draw term loan).

A revolving credit line allows borrowers to draw down, repay, and reborrow. The facility acts much like a corporate credit card, except that borrowers are charged an annual commitment fee on unused amounts, which drives up the overall cost of borrowing (the facility fee). Revolvers to speculative-grade issuers are often tied to borrowing-base lending formulas. This limits borrowings to a certain percentage of collateral, most often receivables and inventory. Revolving credits often run for 364 days. These revolving credits—called, not surprisingly, 364-day facilities—are generally limited to the investment-grade market. The reason for what seems like an odd term is that regulatory capital guidelines mandate that, after one year of extending credit under a revolving facility, banks must then increase their capital reserves to take into account the unused amounts. Therefore, banks can offer issuers 364-day facilities at a

lower unused fee than a multiyear revolving credit. There are a number of options that can be offered within a revolving credit line:

- A swingline is a small, overnight borrowing line, typically provided by the agent.
- A multicurrency line may allow the borrower to borrow in several currencies.
- A competitive-bid option (CBO) allows borrowers to solicit the best bids from its syndicate group. The agent will conduct what amounts to an auction to raise funds for the borrower, and the best bids are accepted. CBOs, typically, are available only to large, investment-grade borrowers.
- A term-out will allow the borrower to convert borrowings into a term loan at a given conversion date. This, again, is usually a feature of investment-grade loans. Under the option, borrowers may take what is outstanding under the facility and pay it off according to a predetermined repayment schedule. Often the spreads ratchet up if the term-out option is exercised.
- An evergreen is an option for the borrower—with consent of the syndicate group—to extend the facility each year for an additional year.
- A term loan is simply an installment loan, such as a loan one would use to buy a car. The borrower may draw on the loan during a short commitment period and repays it based on either a scheduled series of repayments or a one-time lump-sum payment at maturity (bullet payment). There are two principal types of term loans:
  - An amortizing term loan (A-term loans, or TLa) is a term loan with a progressive repayment schedule that typically runs six years or less. These loans are normally syndicated to banks along with revolving credits as part of a larger syndication. Starting in 2000, A-term loans became increasingly rare, as issuers bypassed the less-accommodating bank market and tapped institutional investors for all or most of their funded loans.
  - An institutional term loan (B-term, C-term, or D-term loans) is a term loan facility carved out for nonbank institutional investors. These loans came into broad usage during the mid-1990s as the institu-

tional loan investor base grew. Until 2001, these loans were, in almost all cases, priced higher than amortizing term loans, because they had longer maturities and back-end-loaded repayment schedules. The tide turned, however, in late 2001, and through 2006 the spread on a growing percentage of these facilities into parity with (in some cases even lower than) revolvers and A-term loans. This is especially true when institutional demand runs high. This institutional category also includes second-lien loans and covenant-lite loans, which are described below.

- LOCs differ, but, simply put, they are guarantees provided by the bank group to pay off debt or obligations if the borrower cannot.
- Acquisition/equipment lines (delayed-draw term loans) are credits that may be drawn down for a given period to purchase specified assets or equipment or to make acquisitions. The issuer pays a fee during the commitment period (a ticking fee). The lines are then repaid over a specified period (the term-out period). Repaid amounts may not be reborrowed.

## Second-Lien Loans

Although they are really just another type of syndicated loan facility, second-lien loans are sufficiently complex to warrant a separate section in this primer. After a brief flirtation with second-lien loans in the mid-1990s, these facilities fell out of favor after the Russian debt crisis caused investors to adopt a more cautious tone. But after default rates fell precipitously in 2003, arrangers rolled out second-lien facilities to help finance issuers struggling with liquidity problems. By 2006, the market had accepted second-lien loans to finance a wide array of transactions, including acquisitions and recapitalizations. Arrangers tap nontraditional accounts—hedge funds, distress investors, and high-yield accounts—as well as traditional CLO and prime fund accounts to finance second-lien loans.

As their name implies, the claims on collateral of second-lien loans are behind those of

first-lien loans. Second-lien loans also typically have less restrictive covenant packages, in which maintenance covenant levels are set wide of the first-lien loans. As a result, second-lien loans are priced at a premium to first-lien loans. This premium typically starts at 200 basis points (bp) when the collateral coverage goes far beyond the claims of both the first- and second-lien loans to more than 1,000 bps for less generous collateral.

There are, lawyers explain, two main ways in which the collateral of second-lien loans can be documented. Either the second-lien loan can be part of a single security agreement with first-lien loans, or they can be part of an altogether separate agreement. In the case of a single agreement, the agreement would apportion the collateral, with value going first, obviously, to the first-lien claims and next to the second-lien claims.

Alternatively, there can be two entirely separate agreements. Here's a brief summary:

- In a single security agreement, the second-lien lenders are in the same creditor class as the first-lien lenders from the standpoint of a bankruptcy, according to lawyers who specialize in these loans. As a result, for adequate protection to be paid the collateral must cover both the claims of the first- and second-lien lenders. If it does not, the judge may choose to not pay adequate protection or to divide it pro rata among the first- and second-lien creditors. In addition, the second-lien lenders may have a vote as secured lenders equal to those of the first-lien lenders. One downside for second-lien lenders is that these facilities are often smaller than the first-lien loans and, therefore, when a vote comes up, first-lien lenders can outvote second-lien lenders to promote their own interests.
- In the case of two separate security agreements, divided by a standstill agreement, the first- and second-lien lenders are likely to be divided into two separate creditor classes. As a result, second-lien lenders do not have a voice in the first-lien creditor committees. As well, first-lien lenders can receive adequate protection payments even if collateral covers their claims, but does not cover the claims of the second-lien

lenders. This may not be the case if the loans are documented together and the first- and second-lien lenders are deemed a unified class by the bankruptcy court.

For more information, we suggest Latham & Watkins' terrific overview and analysis of second-lien loans, which was published on April 15, 2004 in the firm's CreditAlert publication.

## Covenant-Lite Loans

Like second-lien loans, covenant-lite loans are really just another type of syndicated loan facility. But they also are sufficiently different to warrant their own section in this primer.

At the most basic level, covenant-lite loans are loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement. What's the difference?

Incurrence covenants generally require that if an issuer takes an action (paying a dividend, making an acquisition, issuing more debt), it would need to still be in compliance. So, for instance, an issuer that has an incurrence test that limits its debt to 5x cash flow would only be able to take on more debt if, on a pro forma basis, it was still within this constraint. If, not then it would have breached the covenant and be in technical default on the loan. If, on the other hand, an issuer found itself above this 5x threshold simply because its earnings had deteriorated, it would not violate the covenant.

Maintenance covenants are far more restrictive. This is because they require an issuer to meet certain financial tests every quarter whether or not it takes an action. So, in the case above, had the 5x leverage maximum been a maintenance rather than incurrence test, the issuer would need to pass it each quarter and would be in violation if either its earnings eroded or its debt level increased. For lenders, clearly, maintenance tests are preferable because it allows them to take action earlier if an issuer experiences financial distress. What's more, the lenders may be able to wrest some concessions from an issuer that is in violation of covenants (a fee, incremental spread, or additional collateral) in exchange for a waiver.

Conversely, issuers prefer incurrence covenants precisely because they are less stringent. Covenant-lite loans, therefore, thrive only in the hottest markets when the supply/demand equation is tilted persuasively in favor of issuers.

## Lender Titles

In the formative days of the syndicated loan market (the late 1980s), there was usually one agent that syndicated each loan. “Lead manager” and “manager” titles were doled out in exchange for large commitments. As league tables gained influence as a marketing tool, “co-agent” titles were often used in attracting large commitments or in cases where these institutions truly had a role in underwriting and syndicating the loan.

During the 1990s, the use of league tables and, consequently, title inflation exploded. Indeed, the co-agent title has become largely ceremonial today, routinely awarded for what amounts to no more than large retail commitments. In most syndications, there is one lead arranger. This institution is considered to be on the “left” (a reference to its position in a tombstone ad). There are also likely to be other banks in the arranger group, which may also have a hand in underwriting and syndicating a credit. These institutions are said to be on the “right.”

The different titles used by significant participants in the syndications process are administrative agent, syndication agent, documentation agent, agent, co-agent or managing agent, and lead arranger or book runner.

*The administrative agent* is the bank that handles all interest and principal payments and monitors the loan.

*The syndication agent* is the bank that handles, in purest form, the syndication of the loan. Often, however, the syndication agent has a less specific role.

*The documentation agent* is the bank that handles the documents and chooses the law firm.

*The agent title* is used to indicate the lead bank when there is no other conclusive title available, as is often the case for smaller loans.

*The co-agent or managing agent* is largely a meaningless title used mostly as an award for large commitments.

*The lead arranger or book runner* title is a league table designation used to indicate the “top dog” in a syndication.

## Secondary Sales

Secondary sales occur after the loan is closed and allocated, when investors are free to trade the paper. Loan sales are structured as either assignments or participations, with investors usually trading through dealer desks at the large underwriting banks. Dealer-to-dealer trading is almost always conducted through a “street” broker.

### Assignments

In an assignment, the assignee becomes a direct signatory to the loan and receives interest and principal payments directly from the administrative agent.

Assignments typically require the consent of the borrower and agent, although consent may be withheld only if a reasonable objection is made. In many loan agreements, the issuer loses its right to consent in the event of default.

The loan document usually sets a minimum assignment amount, usually \$5 million for pro rata commitments. In the late 1990s, however, administrative agents started to break out specific assignment minimums for institutional tranches. In most cases, institutional assignment minimums were reduced to \$1 million in an effort to boost liquidity. There were also some cases where assignment fees were reduced or even eliminated for institutional assignments, but these lower assignment fees remained rare into 2006, and the vast majority was set at the traditional \$3,500.

One market convention that became firmly established in the late 1990s was assignment-fee waivers by arrangers for trades crossed through its secondary trading desk. This was a way to encourage investors to trade with the arranger rather than with another dealer. This is a significant incentive to trade with arranger—or a deterrent to not trade away, depending on your perspective—because a

\$3,500 fee amounts to between 7 bps to 35 bps of a \$1 million to \$5 million trade.

### Primary assignments

This term is something of an oxymoron. It applies to primary commitments made by off-shore accounts (principally CLOs and hedge funds). These vehicles, for a variety of tax reasons, suffer tax consequence from buying loans in the primary. The agent will therefore hold the loan on its books for some short period after the loan closes and then sell it to these investors via an assignment. These are called primary assignments and are effectively primary purchases.

### Participations

A participation is an agreement between an existing lender and a participant. As the name implies, it means the buyer is taking a participating interest in the existing lender's commitment.

The lender remains the official holder of the loan, with the participant owning the rights to the amount purchased. Consents, fees, or minimums are almost never required. The participant has the right to vote only on material changes in the loan document (rate, term, and collateral). Nonmaterial changes do not require approval of participants. A participation can be a riskier way of purchasing a loan, because, in the event of a lender becoming insolvent or defaulting, the participant does not have a direct claim on the loan. In this case, the participant then becomes a creditor of the lender and often must wait for claims to be sorted out to collect on its participation.

## Derivatives—Loan Credit Default Swaps

Traditionally, accounts bought and sold loans in the cash market through assignments and participations. Aside from that, there was little synthetic activity outside over-the-counter total rate of return swaps. By 2006, however, a nascent market for synthetically trading loans was budding.

Loan credit default swaps (LCDS) are standard derivatives that have secured loans as reference instruments. In June 2006, The

International Settlement and Dealers Association (ISDA) issued a standard trade confirmation for LCDS contracts.

Like all credit default swaps (CDS), LCDS is basically an insurance contract. The seller is paid a spread in exchange for agreeing to buy at par, or a pre-negotiated price, a loan if that loan defaults. LCDS enables participants to synthetically buy a loan by going short the CDS or sell the loan by going long the CDS. Theoretically, then, a loanholder can hedge a position either directly (by buying CDS protection on that specific name) or indirectly (by buying protection on a comparable name or basket of names).

Moreover, unlike the cash markets, which are long-only markets for obvious reasons, the CDS market provides a way for investors to short a loan. To do so, the investor would buy protection on a loan that it doesn't hold. If the loan subsequently defaults, the buyer of protection should be able to purchase the loan in the secondary market at a discount and then deliver it at par to the counterparty from which it bought LCDS contract. For instance, say an account buys five-year protection for a given loan, for which it pays 250 bps a year. Then in year 2 the loan goes into default and the market price falls to 80% of par. The buyer of the protection can then buy the loan at 80 and deliver to the counterpart at 100, a 20-point pickup. Or instead of physical delivery, some buyers of protection may prefer cash settlement in which the difference between the current market price and the delivery price is determined by polling dealers or using a third-party pricing service. Cash settlement could also be employed if there's not enough paper to physically settle all LCDS contracts on a particular loan.

Of course, as of this writing, LCDS market was still in its infancy and therefore additional context is yet to come.

In addition to these specific loan contracts—or single-name LCDS—the market was also developing methods to synthetically trade a basket, or index, of loans synthetically. This is similar to the iBoxx indices for high-yield bonds. Investors can trade into an index of loans at a price. For

instance, it can buy the index at a price today and a month later sell it at the current price to close the position. Or, conversely, it can sell the index at a price and then cover that sale later by buying the index. As this implies, index-based derivatives are a way to take a bet on the market or hedge a portfolio against market risk.

## Pricing Terms

### Rates

Bank loans usually offer borrowers different interest-rate options. Several of these options allow borrowers to lock in a given rate for one month to one year. Pricing on many loans is tied to performance grids, which adjust pricing by one or more financial criteria. Pricing is typically tied to ratings in investment-grade loans and to financial ratios in leveraged loans. Communications loans are invariably tied to the borrower's debt-to-cash-flow ratio.

Syndication pricing options include prime, LIBOR, CD, and other fixed-rate options:

- The prime is a floating-rate option. Borrowed funds are priced at a spread over the reference bank's prime lending rate. The rate is reset daily, and borrowers may be repaid at any time without penalty. This is typically an overnight option, because the prime option is more costly to the borrower than LIBOR or CDs.
- The LIBOR (or Eurodollars) option is so called because, with this option, the interest on borrowings is set at a spread over LIBOR for a period of one month to one year. The corresponding LIBOR rate is used to set pricing. Borrowings cannot be prepaid without penalty.
- The CD option works precisely like the LIBOR option, except that the base rate is certificates of deposit, sold by a bank to institutional investors.
- Other fixed-rate options are less common but work like the LIBOR and CD options. These include federal funds (the overnight rate charged by the Federal Reserve to member banks) and cost of funds (the bank's own funding rate).

### Fees

The fees associated with syndicated loans are the upfront fee, the commitment fee, the facility fee, the administrative agent fee, the letter of credit (LOC) fee, and the cancellation or prepayment fee.

*An upfront fee*, which is the same as an original-issue discount in the bond market, is a fee paid by the issuer. It is often tiered, with the lead arranger receiving a larger amount in consideration of its structuring and/or underwriting the loan. Co-underwriters will receive a lower fee, and then the general syndicate will likely have fees tied to their commitment. Most often, fees are paid on a lender's final allocation. For example, a loan has two fee tiers: 100 bps (or 1%) for \$25 million commitments and 50 bps for \$15 million commitments. A lender committing to the \$25 million tier will be paid on its final allocation rather than on initial commitment, which means that, in this example, the loan is oversubscribed and lenders committing \$25 million would be allocated \$20 million and the lenders would receive a fee of \$200,000 (or 1% of \$20 million). Sometimes upfront fees will be structured as a percentage of final allocation plus a flat fee. This happens most often for larger fee tiers, to encourage potential lenders to step up for larger commitments. The flat fee is paid regardless of the lender's final allocation. Fees are usually paid to banks, mutual funds, and other non-offshore investors as an upfront payment. CLOs and other offshore vehicles are typically brought in after the loan closes as a "primary" assignment, and they simply buy the loan at a discount equal to the fee offered in the primary assignment, for tax purposes.

*A commitment fee* is a fee paid to lenders on undrawn amounts, under a revolving credit or a term loan prior to draw-down. On term loans, this fee is usually referred to as a "ticking" fee.

*A facility fee*, which is paid on a facility's entire committed amount, regardless of usage, is often charged instead of a commitment fee on revolving credits to investment-grade borrowers, because these facilities typically have CBOs that allow a borrower to

solicit the best bid from its syndicate group for a given borrowing. The lenders that do not lend under the CBO are still paid for their commitment.

A *usage fee* is a fee paid when the utilization of a revolving credit falls below a certain minimum. These fees are applied mainly to investment-grade loans and generally call for fees based on the utilization under a revolving credit. In some cases, the fees are for high use and, in some cases, for low use. Often, either the facility fee or the spread will be adjusted higher or lower based on a pre-set usage level.

A *prepayment fee* is a feature generally associated with institutional term loans. This fee is seen mainly in weak markets as an inducement to institutional investors. Typical prepayment fees will be set on a sliding scale; for instance, 2% in year one and 1% in year two. The fee may be applied to all repayments under a loan or “soft” repayments, those made from a refinancing or at the discretion of the issuer (as opposed to hard repayments made from excess cash flow or asset sales).

An *administrative agent fee* is the annual fee typically paid to administer the loan (including to distribute interest payments to the syndication group, to update lender lists, and to manage borrowings). For secured loans (particularly those backed by receivables and inventory), the agent often collects a collateral monitoring fee, to ensure that the promised collateral is in place.

A *letter of credit fee* can be any one of several types. The most common—a fee for standby or financial letters of credit—guarantees that lenders will support various corporate activities. Because these LOCs are considered “borrowed funds” under capital guidelines, the fee is typically the same as the LIBOR margin. Fees for commercial LOCs (those supporting inventory or trade) are usually lower, because in these cases actual collateral is submitted. The LOC is usually issued by a fronting bank (usually the agent) and syndicated to the lender group on a pro rata basis. The group receives the LOC fee on their respective shares, while the fronting bank receives an

issuing (or fronting, or facing) fee for issuing and administering the LOC. This fee is almost always 12.5 bps to 25 bps (0.125% to 0.25%) of the LOC commitment.

### Voting rights

Amendments or changes to a loan agreement must be approved by a certain percentage of lenders. Most loan agreements have three levels of approval: required-lender level, full vote, and supermajority:

- The “required-lenders” level, usually just a simple majority, is used for approval of nonmaterial amendments and waivers or changes affecting one facility within a deal.
- A full vote of all lenders, including participants, is required to approve material changes such as RATS (rate, amortization, term, and security; or collateral) rights, but, as described below, there are occasions when changes in amortization and collateral may be approved by a lower percentage of lenders (a supermajority).
- A supermajority is typically 67% to 80% of lenders and is sometimes required for certain material changes such as changes in amortization (in-term repayments) and release of collateral. Used periodically in the mid-1990s, these provisions fell out of favor by the late 1990s.

### Covenants

Loan agreements have a series of restrictions that dictate, to varying degrees, how borrowers can operate and carry themselves financially. For instance, one covenant may require the borrower to maintain its existing fiscal-year end. Another may prohibit it from taking on new debt. Most agreements also have financial compliance covenants, for example, that a borrower must maintain a prescribed level of equity, which, if not maintained, gives banks the right to terminate the agreement or push the borrower into default. The size of the covenant package increases in proportion to a borrower's financial risk. Agreements to investment-grade companies are usually thin and simple. Agreements to leveraged borrowers are often much more onerous.

The three primary types of loan covenants are affirmative, negative, and financial.

*Affirmative covenants* state what action the borrower must take to be in compliance with the loan, such as that it must maintain insurance. These covenants are usually boilerplate and require a borrower to pay the bank interest and fees, maintain insurance, pay taxes, and so forth.

*Negative covenants* limit the borrower's activities in some way, such as regarding new investments. Negative covenants, which are highly structured and customized to a borrower's specific condition, can limit the type and amount of investments, new debt, liens, asset sales, acquisitions, and guarantees.

*Financial covenants* enforce minimum financial performance measures against the borrower, such as that he must maintain a higher level of current assets than of current liabilities. The presence of these maintenance covenants—so called because the issuer must maintain quarterly compliance or suffer a technical default on the loan agreement—is a critical difference between loans and bonds. Bonds and covenant-lite loans (see above), by contrast, usually contain incurrence covenants that restrict the borrower's ability to issue new debt, make acquisitions, or take other action that would breach the covenant. For instance, a bond indenture may require the issuer to not incur any new debt if that new debt would push it over a specified ratio of debt to EBITDA. But, if the company's cash flow deteriorates to the point where its debt to EBITDA ratio exceeds the same limit, a covenant violation would not be triggered. This is because the ratio would have climbed organically rather than through some action by the issuer.

As a borrower's risk increases, financial covenants in the loan agreement become more tightly wound and extensive. In general, there are five types of financial covenants—coverage, leverage, current ratio, tangible net worth, and maximum capital expenditures:

- A coverage covenant requires the borrower to maintain a minimum level of cash flow or earnings, relative to specified expenses, most often interest, debt service (interest

and repayments), fixed charges (debt service, capital expenditures, and/or rent).

- A leverage covenant sets a maximum level of debt, relative to either equity or cash flow, with the debt-to-cash-flow level being far more common.
- A current-ratio covenant requires that the borrower maintain a minimum ratio of current assets (cash, marketable securities, accounts receivable, and inventories) to current liabilities (accounts payable, short-term debt of less than one year), but sometimes a “quick ratio,” in which inventories are excluded from the numerator, is substituted.
- A tangible-net-worth (TNW) covenant requires that the borrower have a minimum level of TNW (net worth less intangible assets, such as goodwill, intellectual assets, excess value paid for acquired companies), often with a build-up provision, which increases the minimum by a percentage of net income or equity issuance.
- A maximum-capital-expenditures covenant requires that the borrower limit capital expenditures (purchases of property, plant, and equipment) to a certain amount, which may be increased by some percentage of cash flow or equity issuance, but often allowing the borrower to carry forward unused amounts from one year to the next.

## Mandatory Prepayments

Leveraged loans usually require a borrower to prepay with proceeds of excess cash flow, asset sales, debt issuance, or equity issuance.

*Excess cash flow* is typically defined as cash flow after all cash expenses, required dividends, debt repayments, capital expenditures and changes in working capital. The typical percentage required is 50% to 75%.

*Asset sales* are defined as net proceeds of asset sales, normally excluding receivables or inventories. The typical percentage required is 100%.

*Debt issuance* is defined as net proceeds from debt issuance. The typical percentage required is 100%.

*Equity issuance* is defined as the net proceeds of equity issuance. The typical percentage required is 25% to 50%.

Often, repayments from excess cash flow and equity issuance are waived if the issuer meets a preset financial hurdle, most often structured as a debt/EBITDA test.

### **Collateral**

In the leveraged market, collateral usually includes all the tangible and intangible assets of the borrower and, in some cases, specific assets that back a loan.

Virtually all leveraged loans and some of the more shaky investment-grade credits are backed by pledges of collateral. In the asset-based market, for instance, that typically takes the form of inventories and receivables, with the amount of the loan tied to a formula based off of these assets. The common rule is that an issuer can borrow against 50% of inventory and 80% of receivables. Naturally, there are loans backed by certain equipment, real estate, and other property.

In the leveraged market, there are some loans—since the early 1990s, very few—that are backed by capital stock of operating units. In this structure, the assets of the issuer tend to be at the operating-company level and are unencumbered by liens, but the holding company pledges the stock of the operating companies to the lenders. This effectively gives lenders control of these units if the company defaults. The risk to lenders in this situation, simply put, is that a bankruptcy court collapses the holding company with the operating companies and effectively renders the stock worthless. In these cases, which happened on a few occasions to lenders to retail companies in the early 1990s, loan holders become unsecured lenders of the company and are put back on the same level with other senior unsecured creditors.

### **Springing liens/collateral release**

Some loans have provisions that borrowers that sit on the cusp of investment-grade and speculative-grade must either attach collateral or release it if the issuer's rating changes.

A 'BBB' or 'BBB-' issuer may be able to convince lenders to provide unsecured financing, but lenders may demand springing liens in the event the issuer's credit quality deteriorates.

Often, an issuer's rating being lowered to 'BB+' or exceeding its predetermined leverage level will trigger this provision. Likewise, lenders may demand collateral from a strong, speculative-grade issuer, but will offer to release under certain circumstances, such as if the issuer loses its investment-grade rating.

### **Change of control**

Invariably, one of the events of default in a credit agreement is a change of issuer control.

For both investment-grade and leveraged issuers, an event of default in a credit agreement will be triggered by a merger, an acquisition of the issuer, some substantial purchase of the issuer's equity by a third party, or a change in the majority of the board of directors. For sponsor-backed leveraged issuers, the sponsor's lowering its stake below a preset amount can also trip this clause.

### **Asset-based lending**

Most of the information above refers to "cash flow" loans, loans that may be secured by collateral, but are repaid by cash flow. Asset-based lending is a distinct segment of the loan market. These loans are secured by specific assets and usually governed by a borrowing formula (or a "borrowing base"). The most common type of asset based loans are receivables and/or inventory lines. These are revolving credits that have a maximum borrowing limit, say \$100 million, but also have a cap based on the value of an issuer's pledged receivables and inventories. Usually, the receivables are pledged and the issuer may borrow against 80%, give or take. Inventories are also often pledged to secure borrowings. However, because they are obviously less liquid than receivables, lenders are less generous in their formula. Indeed, the borrowing base for inventories is typically in the 50% to 65% range. In addition, the borrowing base may be further divided into subcategories—for instance, 50% of work-in-process inventory and 65% of finished goods inventory.

In many receivables-based facilities, issuers are required to place receivables in a "lock box." That means that the bank lends against

the receivable, takes possession of it and then collects it to pay down the loan.

In addition, asset-based lending is often done based on specific equipment, real estate, car fleets, and an unlimited number of other assets.

#### **Loan math—the art of spread calculation**

Calculating loan yields or spreads is not straightforward. Unlike most bonds, which have long no-call periods and high-call premiums, most loans are prepayable at any time typically without prepayment fees. And, even in cases where prepayment fees apply, they are rarely more than 2% in year one and 1% in year two. Therefore, affixing a spread-to-maturity or a spread-to-worst on loans is little more than a theoretical calculation.

This is because an issuer's behavior is unpredictable. It may repay a loan early because a more compelling financial opportunity presents itself or because the issuer is acquired or because it is making an acquisition and needs a new financing. Traders and investors will often speak of loan spreads, therefore, as a spread to a theoretical call. Loans, on average, between 1997 and 2004 had a 15-month average life. So, if you buy a loan with a spread of 250 bps at a price of 101, you might assume your spread-to-expected-life as the 250 bps less the amortized 100 bps premium or LIBOR+170. Conversely if you bought the same loan at 99, the spread-to-expected life would be LIBOR+330.

#### **Bits And Pieces**

What follows are definitions to some common market jargon not found elsewhere in this primer, but used constantly as short-hand in the loan market:

- **Staple financing.** Staple financing—or staple-on financing—is a financing agreement “stapled on” to an acquisition, typically by the M&A advisor. So, if a private equity firm is working with an investment bank to acquire a property, that bank, or a group of banks, may provide a staple financing to ensure that the firm has the wherewithal to complete the deal. Because the staple financing provides guidelines on both structure and leverage, it typically forms

the basis for the eventual financing that is negotiated by the auction winner, and the staple provider will usually serve as one of the arrangers of the financing, along with the lenders that were backing the buyer.

- **Break prices.** Simply, the price at which loans or bonds are initially traded into the secondary market after they close and allocate. It is called the break price because that is where the facility breaks into the secondary market.
- **Market-clearing level.** As this phrase implies, the price or spread at which a deal clears the primary market. (Seems to be an allusion to a high-jumper clearing a hurdle.)
- **Running the books.** Generally the loan arranger is said to be “running the books,” i.e., preparing documentation and syndicating and administering the loan.
- **Disintermediation.** Disintermediation refers to the process where banks are replaced (or disintermediated) by institutional investors. This is the process that the loan market has been undergoing for the past 20 years. Another example is the mortgage market where the primary capital providers have evolved from banks and savings and loans to conduits structured by Fannie Mae, Freddie Mac, and the other mortgage securitization shops. Of course, the list of disintermediated markets is long and growing. In addition to leveraged loans and mortgages, this list also includes auto loans and credit card receivables.
- **Loss given default.** This is simply a measure of how much creditors lose when an issuer defaults. The loss will vary depending on creditor class and the enterprise value of the business when it defaults. Naturally, all things being equal, secured creditors will lose less than unsecured creditors. Likewise, senior creditors will lose less than subordinated creditors. Calculating loss given default is tricky business. Some practitioners express loss as a nominal percentage of principal or a percentage of principal plus accrued interest. Others use a present value calculation using an estimated discount rate, typically 15% to 25%, demanded by distressed investors.
- **Recovery.** Recovery is the opposite of loss given default—it is the amount a creditor recovers, rather than loses, in a given default.

- **Printing a deal.** Refers to the price or spread at which the deal printed.
- **Relative value.** This can refer to the relative return or spread between (1) various instruments of the same issuer, comparing for instance the loan spread with that of a bond; (2) loans or bonds of issuers that are similarly rated and/or in the same sector, comparing for instance the loan spread of one 'BB' rated healthcare company with that of another; and (3) spreads between markets, comparing for instance the spread on offer in the loan market with that of high-yield or corporate bonds. Relative value is a way of uncovering undervalued, or overvalued, assets.
- **Rich/cheap.** This is terminology imported from the bond market to the loan market. If you refer to a loan as rich, it means it is trading at a spread that is low compared with other similarly rated loans in the same sector. Conversely, referring to something as cheap means that it is trading at a spread that is high compared with its peer group. That is, you can buy it on the cheap.
- **Distressed loans.** In the loan market, loans traded at less than 80 cents on the dollar are usually considered distressed. In the bond market, the common definition is a spread of 1,000 bps or more. For loans, however, calculating spreads is an elusive art and therefore a more pedestrian price measure is used.
- **Default rate.** Calculated by either number of loans or principal amount. The formula is similar. For default rate by number of loans: the number of loans that default over a given 12-month period divided by the number of loans outstanding at the beginning of that period. For default rate by principal amount: the amount of loans that default over a 12-month period divided by the total amount outstanding at the beginning of the period. Standard & Poor's defines a default for the purposes of calculating default rates as a loan that is either (1) rated 'D' by Standard & Poor's, (2) to an issuer that has filed for bankruptcy, or (3) in payment default on interest or principal.
- **Default.** There are two primary types of loan defaults: technical defaults and the much more serious payment defaults. Technical defaults occur when the issuer violates a provision of the loan agreement. For instance, if an issuer doesn't meet a financial covenant test or fails to provide lenders with financial information or some other violation that doesn't involve payments. A payment default, as the name implies, happens when a company misses either an interest or principal payment. There is often a pre-set period of time, say 30 days, during which an issuer can cure a default (the "cure period"). After that, the lenders can take appropriate action, up to and including accelerating, or calling, the loan.
- **Leveraged loans.** Just what is a leveraged loan is a discussion of long standing in the loan market. Some participants use a spread cut-off: i.e., any loan with a spread of LIBOR+125 or LIBOR+150 or higher qualifies. Others use rating criteria: i.e., any loan rated 'BB+' or lower qualifies. But what of loans that are not rated? At Standard & Poor's LCD we have developed a more complex definition. We include a loan in the leveraged universe if it is rated 'BB+' or lower or it is not rated or rated 'BBB-' or higher but has (1) a spread of LIBOR +125 or higher and (2) is secured by a first or second lien. Under this definition, a loan rated 'BB+' that has a spread of LIBOR+75 would qualify, but a non-rated loan with the same spread would not. It is hardly a perfect definition, but one that Standard & Poor's thinks best captures the spirit of loan market participants when they talk about leveraged loans.
- **Middle market.** The loan market can be roughly divided into two segments: large corporate and middle market. There are as many ways to define middle market as there are bankers. But, in the leveraged loan market, the standard has become an issuer with no more than \$50 million of EBITDA. Based on this, Standard & Poor's uses the \$50 million threshold in its reports and statistics.
- **Axe sheets.** These are lists from dealers with indicative secondary bids and offers for loans. Axes are simply price indications. ●