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A PRIMER ON LEVERAGED FINANCE

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There was a time years ago when commercial and industrial corporations were not heavy borrowers and the term leveraged finance did not exist. This was after the Great Depression, when it was felt that too much debt would get a company into trouble. My father had this attitude. He was a business man who felt borrowing was a sign of weakness. Bankers had this attitude, which led to comments such as the following: "A banker will only give you an umbrella when it is not raining."

Attitudes began to change in the 1950s and 1960s, as memories of the Great Depression receded. A major breakthrough was the work of Modigliani and Miller, who published an article in 1958 in the American Economic Review. The article upended so-called "conventional wisdom" about corporate debt and capital structures by stating in effect that the value of a company had nothing to do with how the company was financed. The company's value, in their view, was based on the present value of the future cash flows of the company. If you subscribe to this idea, then you can only come to the conclusion that debt is good, and the more the better. Professors started to teach this theory, and their students (who eventually became Professors, CEOs, CFOs as well as investment and commercial bankers) joined in the party and encouraged companies to borrow more.

Soon leveraged lending came into prominence, including leveraged buyouts (“LBOs”) sponsored by the private-equity industry. Leveraged lending generally refers to loans to a company which is either heavily indebted or will be as a result of the loan. In many cases, leveraged lending is made to a below investment grade company or is lending which could lead to an investment grade company being rated at below investment grade. In short, leveraged lending means a lot of debt as the name implies.

LBOs are a method of buying companies using the credit worthiness of the acquired companies (see discussion later) and which are financed by senior secured bank debt and high-yield (“junk”) bonds. The activities of Michael Milken’s Drexel Burnham, which specialized in junk bonds, led to an explosion of leveraged finance (as defined below). Extensive borrowing became the smart thing to do. As a result, over the last 40 years or so credit ratings of even prominent companies have plummeted. Today there are only two companies rated AAA: Microsoft and Johnson & Johnson. Johnson & Johnson has just announced a split of its consumer products and healthcare companies into two public companies which is expected to occur in the next year or two. It is too early to tell what the ratings of the two separate companies will be.

According to a New York Times article (see “AAA Rating is a Rarity in Business” by Eric Dash, 8/2/11 issue): “In the early 1980s around 60 companies had AAA ratings.” Over time, the article pointed out, companies no longer had it as a priority to maintain high credit ratings. The article also states: “Analysts say corporate buyouts and acquisitions accelerated the trend. Many AAA companies lost their ratings when they were taken over and their new owners loaded them with cheap debt to help pay for the deal.”

The fact that interest rates have steadily come down in the last 40 years is another reason why companies have loaded up on debt. I recall very clearly that there was a time in the late 1970s and early 1980s when the three-month London Interbank Overnight Rate (“LIBOR”) was over

20%. LIBOR has been the standard reference rate for floating rate loans for many years. As debt became cheaper, the desire for debt financing grew.

Leveraged finance, generally speaking, refers to riskier situations with a good deal of debt. This most often consists of debt rated below investment grade. Moody's investment grade bonds are rated from Aaa to Baa3, and junk bonds are rated from Ba1 to C. S&P and Fitch bond investment grade ratings range from AAA to BBB-; junk bonds range from BB+ to D. These rating categories are applicable to senior secured bank debt as well as bonds.

Leveraged finance "took off" in the 1980s. The leveraged finance market in the U.S. is now over $3 trillion, with more than half of this in junk bonds and most of the remainder in below-investment-grade loans. Some 40 years ago, the leveraged finance market was miniscule, with totals significantly below $100 billion.

There can be no doubt that leveraged finance is not just a major asset class, it is a dominating asset class.

Private Equity, Leveraged Loans and Junk Bonds

What is private equity? This was a relatively new method of financing, used primarily for LBOs. A private-equity firm such as KKR (Kohlberg Kravitz Roberts) would sponsor the acquisition of a public company and take it private. Corporate acquisitions were traditionally made by strategic buyers. However, with the rise of LBOs, corporate acquisitions were increasingly made by financial buyers, commonly referred to as buyout shops or private-equity concerns.

A strategic buyer that had its own business might buy a corporation which in some way might enhance the buyer's core business. The buyer could purchase the company either by issuing stock to finance the purchase or by cash, typically by raising financing on the basis of its (the strategic buyer's) credit -worthiness. This type of M&A (mergers and acquisitions) business usually was advised by a major investment bank which helped the acquiring company raise financing to pay for the acquisition. The company to be acquired would also be advised by an investment bank. M&A has always been big business for investment banks.

Until the advent of the LBO, strategic buyers and financial buyers relied on the strength of the buyers to finance acquisitions. What the LBO did for the first time was to utilize the credit-worthiness of the target company to raise the money to fund the acquisition. This was a major innovation that can only be described as revolutionary. A good example was the massive $25 billion purchase by KKR of RJR Nabisco in the late 1980s. A fund controlled by KKR put in a small amount of equity. The $24.8 billion acquisition was financed by $16.7 billion in bank debt, $5 billion in junk bonds, $1.1 billion from excess cash of the target, and only $2 billion from the KKR fund.

RJR Nabisco was for many years the largest LBO on record. How was the debt to be paid? RJR owned a variety of companies which were spun off with the proceeds used to reduce the debt. In addition, the cash flows from the remaining RJR companies were quite strong and more than able to service the debt of the company.

Here is a lesson that I learned with the advent of LBOs: a strong stable business with fairly predictable cash flows and high market values has the ability to raise huge amounts of debt. **The debt may be considered excessive by traditional metrics and is therefore rated below investment grade. However, the debt is not necessarily extremely risky. The secret to a successful LBO is to buy a very good stable business and load it up with debt that the business is able to service**. The bank lenders were given a senior secured position, and the high -yield bond debt was given (as its name suggests) high yields. I always said that, if a company is very highly leveraged, that should be the only thing wrong with it. In other words, loading up a really great businesses with a lot of debt need not be extremely risky. These businesses should have a predictable and stable cash flow. They should have assets and subsidiaries with high market values.

Two of the principal characters in the LBO drama were Jimmy Lee of Chemical Bank and Michael Milken of Drexel Burnham. Chemical Bank would organize a syndicate of banks to lend the senior debt, and Mike Milken would arrange for junk bonds to be sold to institutional investors.

Over the last 30 or 40 years, LBOs have become big business not only in the U.S. but all over the world. Banks, which were traditionally very conservative lenders, were the major senior secured lenders in the earlier years of the LBO phenomenon.

Leveraged Finance is More than Just LBOs, and nowadays Private Equity is more than LBOs

There is no doubt that the growth of leveraged finance over the years has been fueled by leveraged buyouts. However, leveraged finance now is utilized for a variety of other reasons. For example, companies may borrow money to pay dividends to their owners or even to buy back shares. In the "old days" this sort of thing would have been labelled as "nonproductive" and would have been looked down upon even by the financial community. This is no longer the case. Companies now routinely borrow money for all sorts of purposes and rely less on equity for financing. CFOs of companies no longer want to maintain high credit ratings. They are satisfied to have BBB ratings and even lower (junk) ratings. As noted before, debt is now considered good.

Major private- equity companies include KKR, Apollo, Carlyle and Blackstone. They were originally referred to as buyout shops. They now prefer to be called alternative asset managers. They are engaged not only in LBOs (with equity investments) but also in debt financing. Over the years, these companies have been highly successful. They now also make large investments in less- risky opportunities with equity and debt investments. These private-equity companies now are considered as multi-purpose alternative asset managers.

The Dangers of Leveraged Finance

The dangers of leveraged finance can be masked in a low- interest- rate period. This could change if and when interest rates start creeping up, which is very possible now that we seem to be entering into an inflationary period. Leveraged loans in general are floating-rate loans, and the interest on these loans will float upwards as interest rates increase.

A major danger of leveraged finance is that we are living in an environment in which there is just too much money chasing too few deals. Furthermore, in a low-interest-rate environment, investors are "reaching for yield" and are becoming more and more careless. A major problem is "covenant lite". Perhaps 80% of deals today do not have adequate covenant protection. ("Covenant lite" refers to the easing of terms and conditions in loan and bond purchase agreements.) In addition, leverage is increasing because lenders are willing to overlook high Debt/EBITDA (earnings before income taxes, depreciation and appreciation) ratios. Furthermore, EBITDA is more and more being subjected to upward adjustments, which is another way of tolerating dangerously high levels of debt that perhaps will crush more and more companies.

Evolution of Leveraged Loan Market

The leveraged loan market started out in the 1980s as a bank market. A major bank would syndicate a credit and sell out participations to other banks in the U.S. including foreign banks here. The major syndicators were Chemical Bank, Bank of America, Chase and other major U.S. banks. Eventually, the loans were syndicated to nonbanks. This occurred after the Great Financial Crisis ("GFC"), when regulations made it more punitive in terms of capital requirements for banks to lend--especially to below- investment- grade borrowers. Now, the major buyers of these syndicated loans are CLOs (collateralized loan obligations), which own about 2/3 of all syndicated leveraged loans in the U.S. market.

CLOs and how they operate

A CLO is an investment vehicle specifically created to own leveraged loans, which, as previously noted, are principally senior secured floating rate loans. A CLO is typically financed by a small amount of equity (approximately 10%) with the remainder financed by tiered floating-rate debt instruments. About 65% of the financing comes from AAA bonds, which have a first-priority position on the CLO assets; the remaining debt (about 25% of the financing) comes from tiered, lower- graded debt (rated AA, A, BBB and BB), which has second, third, etc. priority claims on the CLO assets.

In difficult times, CLOs have performed well. During the GFC, no debt holder lost money because of credit considerations. As a matter of fact, very few CLO bondholders to date have ever lost any money because of credit considerations. During the GFC in 2008-09, the CLO market performed quite well. There were concerns at the beginning of Covid-19 that the CLO market would suffer because CLOs are a subset of what is known as CDOs (collateralized debt obligations). The problems feared have never materialized. One of the reasons for the fears was because mortgage-backed securities and collateralized mortgage obligations (which also are subsets of the overall CDO market) were instrumental in causing the melt -down that occurred in 2008-09. This fear of CLOs has proven to be misplaced.

Before the GFC, BBB and below- investment -grade CLO debt holders did lose some money, but the amounts were negligible. These losses were incurred by investors in CLOs whose asset managers carelessly deviated from industry norms.

I have spoken to CLO managers and have been told that the current CLO structures are so robust that it would take exceptionally poor investment decisions to jeopardize principal even in below -investment-grade tranches.

A major advantage of CLOs is the diversification of credit risks. Other advantages include the fact that most of the CLO assets consist of senior secured leveraged loans, which are highly credit-worthy by and large, despite their below- investment -grade ratings. A final advantage is the fact that the loans are floating-rate so that, if and when interest rates go up, the loans should not lose market value.

Despite the positive factors cited above, investors need to be aware that the lower tranches and the equity portions of CLOs do carry some credit risk in the event that the overall senior secured lending market runs into difficulties resulting from adverse economic conditions which, as we have seen, are a possibility. The most exposed to credit risk is the equity portion of a CLO, because equity takes the “first hit” if credit problems develop in the CLO portfolio. The tradeoff is that equity has an “upside” in good times, as we are seeing now.

Advantages and Disadvantages of Leveraged Loans and Junk Bonds: history of how I got involved in the Leveraged Loan and Junk Bond markets.

I was working for a foreign bank in the 1980s when we were invited to the famous "Predator's Ball", the Drexel Burnham annual High Yield Conference in Beverly Hills. Drexel was targeting foreign banks and encouraging them to get into the junk bond market. At the time, I was highly skeptical about the high-yield market but did not know much about it. Several of us went to the conference and much to our surprise, we were impressed by the quality of the issuers that Drexel counted as its customers. At the time, many junk bond issuers also had senior secured bank loans in their capital structure. When we came back to New York and reviewed what we wanted to do, we came up with the idea that we could easily make credit available to many of the same companies by making senior secured bank loans rather than buying their junk bonds.

Such an approach would be easy for us because top U.S. banks were syndicating loans to these companies. In those days, banks would syndicate loans only to other banks. We took advantage of this opportunity.

Why would we prefer Leveraged Loans to Junk Bonds?

(1) No funding risk for banks making leveraged loans. Our funding consisted primarily of overnight deposits or shorter-term deposits, typically in the Eurodollar markets. Leveraged loans were designed to be sold to banks that could fund themselves in this market. Let's assume that we took a $10 million participation from, for example, Bank of America for five years. Our senior secured borrower would have the option of picking its interest period (usually one month, two months, three months, six months or one year). Every time the borrower picked an interest period, we would borrow money in the Eurodollar market for the same period. Assume that the loans were priced at LIBOR + 2%. We would borrow money at LIBOR and get a 2% spread as the "profit". This was very simple in concept and in process.

(2) Funding risk for banks investing in junk bonds. Corporate bonds are fixed-rate instruments and were not meant to be bought by banks, which traditionally obtain short- term funding. I started out my career at an insurance company and was involved in what is now referred to as SME (small and medium-sized businesses) private placement of bonds. Insurance companies and pension funds have long-term, fairly predictable liabilities the "cost" of which does not vary significantly. (For example, insurance companies get funds from the insured which pay premiums periodically. Based on actuarial tables, the insurance company has a good idea of when funds will be paid out and what the cost these funds is and which rate generally turns out to be stable.) The purchasers of corporate bonds have traditionally been these types of institutions.

If we, as a bank, were to buy junk bonds—or any bonds for that matter—we most likely would have to fund these with either short -term liabilities (bank deposits are generally shorter term) or floating rate debt (which is not a good funding match for fixed rate assets in a rising rate environment). There would be a mismatch in the tenor of the bond and the funding. If rates went up, the value of the bond would go down at the same time that the cost of our funding would go up. This did not seem to be an attractive proposition for us.

(3) Leveraged Loans are senior secured loans covered by collateral and otherwise have a priority of position over junk bonds. When looking at any particular company, one notes that leveraged loans are less risky than high-yield bonds. I have been involved in 100s of transactions in leveraged finance, including leveraged loans and junk bonds. In my years of banking at several different institutions, we never lost any principal in any senior secured bank loan, even in cases of bankruptcy because there was sufficient collateral to cover our loans when the relevant company was reorganized.

(4) Junk bonds in general are riskier than leveraged loans. During my years in banking, we invested also in junk bonds. A small percentage of the bonds developed problems, including bankruptcies. We lost some money on a small percentage of these bonds. However, looked at from a portfolio point of view, the rates on the junk bonds were so high that we still earned a decent return on our overall investment.

(5) Are senior secured leveraged loans an opportunity for institutional investors such as insurance companies and pension funds? There has been some reluctance by the insurance and pension fund industries to buy leveraged loans. This is partly due to inertia, inasmuch as these companies are traditionally fixed-income bond buyers. However, rates are very low now; in an inflationary environment in which floating rates will go up, this seems like a good opportunity for these institutions to buy these loans. This would give these institutions an "upside" when rates go up, and it will also give them more diversification in their investment portfolios.

Which type of investment is more lucrative--leveraged loans or junk bonds?

I have discussed this with academic experts in the junk bond market and have been told that, to their knowledge, there has never been a study to investigate this question. My "gut" reaction is that, in general, senior secured leveraged loans are a "better deal" than junk bonds. (Of course, a "BB"-rated junk bond is less risky, at least in theory, than a "C"-rated leveraged loan).

Leveraged Loans and junk bonds evolving towards "covenant lite"

When I was making term loans or putting together bond financings years ago, the loan or bond purchase agreement contained a full set of covenants, including air- tight security requirements, limitations on debt, liquidity requirements and certain controls on the types of business that the company could engage in, and requirements regarding management. In addition, there were strict requirements regarding mergers and acquisitions and restricted payments.

The idea was for the creditors to have control of the borrower—not just if problems developed but even before problems developed.

Gradually, over the years, so much more liquidity seems to have entered into the financial system that the borrower can now call the shots. We now have "covenant lite" (a scaled down and less restrictive set of covenants) in perhaps 80% or more of the leveraged financings today. When there is too much money chasing too few deals, "covenant lite" is inevitable.

What is Leverage?

Traditionally, leverage has been defined as the relationship between debt to equity. The higher the debt/equity ratio, the higher the leverage. Debt/Equity is still the formula for calculating the leverage of finance companies including banks.

Leverage in non-bank corporate finance is now defined as Total Debt/EBITDA. Ratings from rating agencies such as Moody's and S&P are to a great extent based on this ratio. The higher the ratio, the lower the rating.

One of the problems with this ratio is that EBITDA is supposed to represent the cash flow of the business. However, EBITDA can be manipulated, as we have seen in recent years. Usually, it is adjusted upwards, which gives the company an appearance of being stronger than it is. The SEC has been quite vocal in its condemnation of unwarranted upward adjustments to EBITDA. An egregious example of this type of manipulation was employed by WeWork, which came up with "Community Adjusted EBITDA" in which all sorts of common and recurring expenses were added back to inflate the EBITDA figure. This creative accounting "converted" a company draining cash into one that appeared to be cash-flow positive. As we all now know, this did not end well. WeWork went into Chapter 11 bankruptcy and it emerged from bankruptcy after trimming down its debt and lease obligations. It has recently had a public offering and the hope is that WeWork's fortunes will be better this time.

Due Diligence in Investing in Leveraged Finance Products

I have always had the feeling that a lender should first try to understand the industry and business involved. If you don't understand the business or find that it is too risky, you have no business lending to it. Once a lender has identified the key business and industry risks, it should make sure that these are sufficiently mitigated. Business due diligence is intense work, but it is necessary. Remember that there is very little or no upside in lending money (unless one is buying distressed paper). Lenders or purchasers of corporate bonds typically must be risk-averse.

When one is satisfied with the business risks, it is necessary to do a proper financial analysis. Is the projected cash flow from the business realistic and sufficient to handle the required debt service? Are the market values of assets and subsidiaries substantially high to give additional comfort to the lender? This is a highly simplified explanation of what due diligence entails. My own particular rule has always been this: a highly leveraged company is by definition risky. There had better not be any other major problems with the company.

Another aspect of due diligence is to make sure that the covenants in the relevant loan or bond purchase agreement are adequate. Unfortunately, this often does not seem to be the case in the present environment.

In addition, one should not overly rely on credit ratings. I have found that too many investors make ratings a substitute for the good, old-fashioned work called credit analysis and due diligence.

A final element of due diligence relates to the idea of risk/reward. Is the investor being paid sufficiently to compensate for the risks involved? This is admittedly a subjective exercise. It is made much easier when proper due diligence is conducted. It is imperative to understand thoroughly all the risks involved in any kind of debt instrument. Once again: there is usually no upside; there is only a downside.

How Will the Termination of LIBOR affect Leveraged Finance?

Leveraged loans and funding arrangements for leveraged loans (principally CLOs) are highly dependent on LIBOR. Practically all leveraged loans use LIBOR as the reference rate. CLOs fund themselves with bonds that use LIBOR as the reference rate. There is general unease in the CLO industry that the transition away from LIBOR will affect (perhaps adversely) CLOs. This is because the liability side of the CLOs (i.e., floating- rate bonds) have to a good extent made the transition away from LIBOR while the asset side (collateral for the CLO bonds) has not yet made the transition. This is because the asset side consists of individual leveraged loans, which to date have been tardy in making the transition. The result is what is referred to as "basis risk". To what extent this "basis risk" will affect CLOs negatively is not known now.

More generally, the transition away from LIBOR brings up two issues for leveraged loans:

(1) So-called **legacy loans** need to change from LIBOR to another reference rate. Legacy loans are those which have been made before the termination of LIBOR and do not have adequate provisions for a replacement rate for LIBOR. These legacy loans have until June 30, 2023 to come up with an adequate replacement rate. The preferred reference rate in the regulatory community is based on SOFR (Secured Overnight Funding Rate). However, the banking and business communities have been reluctant to change to SOFR and in many cases are looking into alternative rates. It is not clear to what extent SOFR-based reference rates will be used in the legacy loans. If there is no agreement between borrowers and lenders, there will be legislative solutions, which in effect will force the use of SOFR. However, SOFR reference rates have known weaknesses, which are beyond the scope of this article. (For more information on this, see my article in the LA Progressive- https://www.laprogressive.com/libor-going-away).

(2) New loans in the leveraged loan markets will no longer be allowed to use LIBOR beginning January 1st, 2022. As just noted, the preferred reference rate in the regulatory community is SOFR. However, SOFR does not meet the needs of many banks; many would prefer to use other alternative reference rates. To what extent SOFR reference rates are to be accepted is not clear at this point. The major problem in my opinion is that the Fed, the SEC and the Treasury Department among others want SOFR but the market is reluctant.

(3) Since the aforementioned article on the end of LIBOR was published in the LA Progressive (July 17, 2021) the authorities have agreed on a formula for Term SOFR. Term SOFR is a forward-looking rate as is LIBOR. This means that a borrower knows at the beginning of an interest period what the SOFR rate will be for the upcoming period. One of the advantages of LIBOR over SOFR was that LIBOR is a forward- looking rate while SOFR (which has the advantage of being based on actual transactions) was an overnight rate and therefore not a forward-looking rate. The solution to this problem is to create a Term SOFR (which is a forward-looking rate) on the basis of complex calculations based on swaps and futures rates. In other words, Term SOFR is not based on actual transactions even though SOFR is. Some in the regulatory community now think that Term SOFR is a guess and therefore has the same problem

that led to the termination of LIBOR. The fact that Term SOFR is not based on actual cash transactions but on rates in the derivatives markets is a known weakness of Term SOFR.

I have been told by senior bankers that, despite this hesitancy by some regulators, many large banks including JP Morgan Chase, the largest bank in the U.S. are committed to making Term SOFR the default replacement for LIBOR.

Political Threats to Leveraged Finance

Politicians, notably Senator Elizabeth Warren, believe that private-equity companies are evil and cause the loss of jobs. In 2019, Senator Warren (D-Mass.) and Senator Sherwood Brown (D-Ohio) introduced the "Stop Wall Street Looting Act". This effort failed to get a vote then and is being re-introduced now that the Democrats have control of both houses of Congress. The Act does not appear to have much following behind it—certainly not from Republicans and also not from most Democrats. This bill would cripple LBOs, because it would force private-equity funds to be liable for the debts and pension obligations of the funds' portfolio companies. It would end dividend recapitalizations (financing for the purpose of paying dividends) and make general partners of the funds individually liable for certain obligations.

The Internal Revenue Code now places limitations on how much interest can be deducted by leveraged companies. The 2017 Tax Cuts and Jobs Act caps the deductibility of interest on any leveraged company. The maximum deductibility is interest of no more than 30% of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) changing to 30% of EBIT (Earnings Before Interest and Taxes) in 2022. Before these changes, interest deductibility was unlimited.

Are we in a credit bubble?

It is worthwhile to ponder the thinking of private equity chiefs (see "Private Equity Chiefs Wonder How Much Longer the Good Times Can Roll", Financial Times Nov. 17, 2021). Central Bank and Government actions "…helped to propel the industry to new highs, providing easy access to cheap debt with which to strike new deals, keep hard-hit companies afloat and even pay themselves dividends." This will be a record earnings year for most of the big players.

But there is some trepidation: One senior officer of KKR "…likened private equity's use of debt to the way children would approach a box of chocolates placed in front of them." He added that "the combination of hefty valuations, large sums of capital flowing into companies and high leverage created the risk of 'the dotcom boom meeting with the financial crisis.' ".
A senior officer of Apollo "…warned that the sky-high valuations at which private equity firms had struck deals signaled 'a state of collective delusion.' "

Summary and Conclusions

Leveraged finance came into being some 40 years ago. During the last 40 years, interest rates have been trending downward. About 40 years ago LIBOR was over 20%, and now it is close to zero. It is relatively painless to borrow money when rates are low as compared to times when rates are high. To what extent have the leveraged loan and junk bond markets flourished because rates have been trending down? I don't think anyone has a precise answer to this question.

Now, for the first time in 40 years, we are facing a situation in which inflationary pressures are increasing and interest rates will probably go up as a result. If this inflationary situation turns out to be permanent rather than temporary, we will see what the effect will be on the leveraged finance markets. Fixed-rate junk bonds will lose market value as rates go up. Leveraged loans will become more expensive for borrowers as interest rates are adjusted upwards. It is likely that such a situation will lead to more pressure on highly-leveraged companies, which will lead to more defaults and more bankruptcies. We now have a situation in which the covenants in loan agreements do not give a good deal of control to lenders. Are we heading into a day of reckoning when it becomes more obvious than ever that there is such a thing as too much leverage? Time will tell.