

CFA Trending Topics

Week of October 29, 2018

1. Borrower friendly terms indicative of a frothy market?

Key Takeaways

- Robust investor demand in the leveraged finance market in recent years has enabled flexible deal structures and overall higher leverage.
- Add-backs that have inflated projected EBITDA as well as overestimated debt repayment should be considered as it relates to incremental risk at this stage of the credit cycle.

An S&P Global review of a sample of transactions originated during 2015 shows that on an aggregate level, "add-backs" to EBITDA have inflated projections by an average of 45%. This study has also revealed that management projections are almost universally overstated, as 56% and 69% of issuers included in this analysis missed their EBITDA projections by greater than 25% in 2016 and 2017, respectively. To a lesser degree, issuers have also under-delivered on debt repayment projections, as 16% and 31% of these issuers missed their debt projections by greater than 25% in 2016 and 2017, respectively. As a result, actual reported net leverage was 2.9x higher for 2016 and 3.6x higher for 2017. While the concept of EBITDA add-backs is not new, robust credit markets in recent years have increased the acceptance of management forecasted numbers and borrower friendly credit documentation. That does not mean, however, that agencies or lenders take marketing material at face value without forming their own view on leverage and management forecasts.

While this practice exists across the credit spectrum, a recent S&P Global study across single B issuers shows that over 50% of management reported EBITDA is comprised of add-backs. To this end, future event risk may be understated as loan documentation that relies on EBITDA likely provides additional flexibility that would not otherwise exist. However, this concept has enabled borrowers of this size and scale to access robust leveraged loan markets that have supported both organic and inorganic growth opportunities. Issuers have the ability to maneuver under negative covenants and restricted payments such as dividends and future leveraging events that will continue to drive opportunity, notwithstanding potential incremental risk to credit markets. In a stress scenario, investors and markets may deconstruct add-backs and forecasts across highly leveraged transactions and conclude that additional flexibility creates additional opportunity, albeit at a cost.

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