

A Waning Credit Cycle — Why the End Will Be Softer This Time

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Monroe Capital CEO Ted Koenig writes that, while signs point to a credit cycle entering its final stages, he expects a softer landing than in 2007. Attractive investment opportunities for non-bank lenders, ABLs and other non-regulated credit providers are expected to continue, as the new landscape emerges.



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Three years after the credit markets collapsed during the Great Recession, few could say with any certainty whether we would ever again see an environment that resembled the go-go times of 2006-2007. Yet today, it's starting to feel like the current credit cycle is entering the eighth inning to many of us in the finance business. Similar to 2007, we're seeing capital chasing deals, driving leverage and M&A multiples higher. For the most part, covenants are loosening, yields are trending lower and the outliers in both areas are becoming increasingly egregious. This is particularly true, as financial sponsors continue to push the envelope in order to compete in what has become a competitive M&A environment.

That said, considerable differences exist between the credit markets of 2007 and today. While there is still room to run in the cycle today, when it does eventually slow, we do not believe liquidity will disappear to the extent it did in the years following the credit crisis in 2008-2009. Defaults will most likely not trend as high, and it is unlikely that the number of bankruptcies will eclipse the 10-year peak set in early 2010. Nonetheless, identifying who will be active in the market may be as relevant heading into 2016 as it was entering 2011.

Lending Drivers

To get a sense of what's stimulating lending activity, it all begins with funding capacity. As interest rates remain historically low, institutional investors have migrated away from traditional fixed income to find other alternatives for acceptable yield. The private debt market has been among the biggest beneficiaries, particularly recently as investors seek out increased yields and floating-rate debt exposure as a hedge against rising interest rates. According to a Preqin report published in March

2015, the global private debt market stood at \$152 billion in 2006 and had grown to \$465 billion by the end of 2014, with \$154 billion in remaining dry powder. In addition, approximately three out of five institutional investors surveyed by Preqin anticipated increasing their allocations to private debt funds over the next 12 months.

Couple the growth of the private debt funds market with the ongoing expansion of business development companies (BDCs), and the supply drivers fueling middle market corporate debt quickly come into focus (even as regional banks have receded from the picture due to Tier 1 capital regulatory constraints). According to the Small Business Investor Alliance, 84 U.S.-based BDCs currently have more than \$70 billion in outstanding loans to middle market businesses. Since 2011, the sector has witnessed 21 new IPOs. Over the past 18 months alone, BDCs have completed close to 30 follow-on offerings. Again, the growth of the BDC marketplace has been buttressed by investors' hunt for yield in what has otherwise become a "low-return" market. It should also come as no surprise that the bulge bracket investment banks have moved into the space. Goldman Sachs raised roughly \$120 million through an IPO for its inaugural closed-end BDC in March, while Credit Suisse subsequently filed to float its own \$500 million BDC offering.

Signs of a Late-Stage Credit Cycle

As M&A market observers well know, improving credit markets can create a virtuous cycle. Liquidity contributes to rising leverage multiples that augment purchase prices; higher valuations, in turn, entice more sellers into the market and create more deal activity. While not interminable, this is how supply in the debt markets can actually drive demand. In 2014, according to PitchBook Data, median purchase price multiples for buyouts reached 10.7x EBITDA, bolstered by a debt multiple of 6.4x. Each represented high water marks for the asset class from 2006 onward.

Just as we saw in 2007, an influx of liquidity into the market has borrowers attempting to push out the perimeter that frames standard lender terms and protections. Pricing is down, covenants are looser and capital structures are becoming increasingly aggressive. These three factors, perhaps more than anything else, signal the late innings of a credit cycle.

Recently, we passed on a middle market deal involving a private equity sponsor in which the firm was looking to acquire a retailer for 8x TTM EBITDA, levered at 5.75x and priced at Libor +450. The deal, not necessarily atypical today, incorporated too much leverage at pricing that was too thin to accommodate the potential inherent risks.

"Covenant lite" loans — primarily seen in larger cap market companies that can access high yield debt — have been back in vogue since 2013, when the total issuance as a percentage of the market crossed the 50% threshold according to the IMF's Global Financial Stability Report. In the middle market, we saw some trickle down, although covenant-lite typically takes the form of "covenant loose," incorporating non-amortizing debt that's marked by diluted maintenance covenants and higher hurdles to trigger a default (versus the outright elimination of these covenants in the large cap company market).

A Soft Landing

If market conditions are signaling the end of the credit cycle, it's a fair question to ask what the end will indeed look like. While I believe we've reached the late stages of the current credit cycle, the end of this cycle will most likely be the soft landing we had all hoped for back in 2007. In fact, I think certain pockets of the market are already starting to show signs of fatigue, which could provide a preview of things to come.

As PitchBook highlighted in its U.S. PE Breakdown report in April 2015, deal volume fell off by more than 25% sequentially in Q1/15, with purchase price multiples falling to 7.7x EBITDA. Valuations were dragged lower by a median debt percentage that slumped to just 50% of enterprise values, even lower than the roughest stretch of the crisis in 2009 to 2010. Even if debt multiples level off, however, most believe the \$1 trillion-plus of dry powder available to PE investors will prevent a prolonged standstill in the deal market.

I've gone on record predicting that the Federal Reserve won't likely raise rates until at least September. When this does come to pass, be it September or early 2016, it will have an added impact. In fact, the uncertainty around the April FOMC announcement may have contributed to the slowdown in the first quarter. Make no mistake, Fed Chair Janet Yellen is closely watching the debt markets, as she called out the "deterioration in lending standards" as among the key risks of a low-interest rate environment in her testimony in front of the Senate Banking Committee last year. Even as floating-rate loans provide lenders and institutional investors some cushion, rising rates almost always serve to slow demand, even if it's just temporary.

In line with our expectations for a soft landing, we don't believe the end of the credit cycle will necessarily result in a surge of defaults. Certain sectors, such as the energy exploration and production space (already dealing with the oil price shock) or consumer discretionary names (always impacted by economic headwinds) could face more liquidity pressure. Still, we believe companies are generally in far better condition today as it relates to cash on hand, earnings and free cash-flow. Defaults, if they do trend higher, will be a function of overleverage versus underperformance or lack of liquidity.

Changing Landscape

The biggest change to the market will likely be the market participants. Rumors have persisted for years that General Electric might seek out alternatives for its GE Capital division once GE was designated as a Systemically Important Financial Institution (SIFI) in 2013. Speculation became a reality in April of this year, and the news of the coming GE Capital sale reverberated through the market. While it is still too early to know the exact ramifications, there typically is fallout whenever a large player in the financing space exits the market. This will be particularly true if the GE loan business, and specifically, the PE sponsor finance business GE Antares, ends up being acquired by a non-bank lender (such as a Canadian insurance company or pension fund). In that event, the likely increased cost of capital will put more of the private debt providers on a level playing field. Accordingly, middle market borrowers will likely see a modest increase in the cost of their leveraged buyout debt capital.

Elsewhere, the BDC market, which has helped disintermediate the mezzanine debt space in recent years, will likely endure its own shakeout. A rising rate environment in which retail investors may move

away from so-called “bond proxy” stocks could be the catalyst some market observers have been waiting for. Even in today’s flush markets, roughly half of the public BDCs do not generate enough net investment income to cover their own dividends. Many are trading at significant discounts to their net asset values, making new fund raising difficult. Some of these BDCs have seen their public stock prices drop by a third or more in the last 18 months. The better-managed BDCs, typically those that have robust direct origination platforms and a strong credit culture, will rise to the top in terms of earnings and dividends. Meanwhile, the rest will be forced to cut their dividends and make decisions that are not in the best long-term interests of their shareholders.

Window of Opportunity

As we’ve seen in past years, uncertainty always creates opportunities — for up-and-comers, new or forgotten strategies, or players willing to take a steadier and more consistent path of growth. For example, when the economy downshifts, borrowers in the middle market traditionally turn to asset-backed loans, whether it’s for working capital, additional credit capacity or financing structures for tuck-in acquisitions. There is no reason why this won’t be the case, as cash-flow-based loans face moderating leverage multiples and higher pricing. The last downturn helped borrowers see the value of unitranche facilities, as this structure proved to be an efficient and painless option that grew in popularity with the markets post crisis.

Notably, much of our business today at Monroe is in unitranche lending. Peer-to-peer lending platforms are growing, and it will be interesting to see how these loans perform when faced with their first real downturn and liquidity shortage. Borrowers in this new and trendy space will be the first to feel the pinch when and if the economy falters and unemployment rates rise. We also would not be surprised to see regional banks step back into the void, particularly in the ABL arena. This segment, while hamstrung by newly adopted regulations post credit crisis, remains well-capitalized. With a much lower cost of capital and the ability to operate at around 10 times leverage, these banks will typically win the deals they want to win.

In the middle market, though, you win with solid underwriting and credit performance. As we told our BDC investors during a recent earnings call, whenever we are faced with high multiples and looser covenants, that’s typically a signal to rotate out of junior and second-lien facilities into senior-secured first lien or unitranche debt. Today, more than 93% of our public BDC portfolio consists of first lien senior-secured debt. As we have seen time and again, most borrowers and PE firms appreciate consistency by partnering with the same firm, people and decision makers who have had decades of experience working together.