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Leveraged Lending Market Update: 2018 Year in Review and 2019 Outlook

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When asked about investor appetite for leveraged loans in 2019 after the downturn in the market in Q4 2018, some market participants have indicated that they expect appetite will continue, but may come at higher rates compared to 2018: "This is a repricing, not a fundamental shift. The current hypothesis is that the market will find a level and stabilize around a new price. Lenders and investors will go back into the market but that new level won't go back to what it was…"
– GoldSheets, Thompson Reuters LPC, January 14, 2019

2018 was an interesting year for the U.S. leveraged loan market, with three quarters of high leverage levels, low pricing and borrower friendly terms dominating the market, but stalling in the fourth quarter. Although the market has started to rebound (albeit slowly) in January 2019, pricing and documentation terms remain less favorable to sponsors than early 2018.

A Record Year for US Leveraged Loan Issuance

2018 was a record setting year for the U.S. leveraged loan market, with almost $1.24 trillion of leveraged loans issued.

The strong performance can be attributed to a number of factors. One factor was the rising interest rate environment. Investors looked to capitalize on such rising rates by investing in floating-rate assets, like leveraged loans. In the end, there were a total of 4 interest rate hikes implemented in 2018.

In addition, CLO issuance reached an all-time high in 2018, with over $128 billion of CLO's formed based on data from Thomson Reuters LPC.

Sponsored loan and LBO issuance in particular also reached new heights in 2018. According to Thomson Reuters LPC, sponsored loan issuance in 2018 was $647.4 billion, representing the second-highest total on record, and LBO volume surged to $154.0 billion, representing the highest level since 2007[i]. Sponsors took advantage of the favorable market conditions and, as a result, often were able to drive aggressive terms during the first three quarters of the year, such as uncapped EBITDA add-backs, various carve-outs to MFN pricing protection, asset sale prepayment stepdowns and uncapped investments in non-guarantor foreign subsidiaries, among other terms.

2018 also saw a rise in leverage levels and the number of covenant-lite loans in the market. 73% of all buyout financings were leveraged at or above 6.0x and 41% were leveraged at or above 7.0x, which is the highest level seen since 2007.[ii] In addition, over 79% of institutional new issuance in 2018 was covenant-lite.[iii] The increase is due, in part, to the Trump administration's focus on de-regulation and an announcement by governmental agencies in mid-September, which clarified that the leveraged lending guidelines – issued in 2013 to curb risky underwriting practices – do not have the force of law and will not be the basis of enforcement actions.

4Q18: Volatility Sweeps In

Although 2018 was a strong year taken as a whole, the year likely will be most remembered for the turbulence that hit the market in the fourth quarter due to the convergence of a variety of macro-economic factors, including a declining stock market, uncertainty around Brexit, excess supply of leveraged loans and uncertainty regarding the impact of the Trump administration's trade policy with China.

The result: new issue volume in the fourth quarter dropped to the lowest levels seen since January 2016. The fourth quarter of 2018 also saw investors increasingly exercise flex rights to widen pricing and tighten terms. Some borrowers chose to pull or postpone deals as a whole, in the hopes that 2019 would present more favorable market conditions, though the pipeline for January is not as large as was present several years ago in similar conditions.

Outlook for 2019

While it is still too soon to tell what the state of the market will be for 2019 as a whole, thus far in January, the market has started to stabilize and rebound somewhat.

Political uncertainty remains a constant following the longest government shutdown in U.S. history, but the financial markets were pleased by an announcement by the Federal Reserve on January 30, 2019 that it would not increase interest rates in January and that it would be "patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate".[iv] Arrangers are marketing and allocating deals that were postponed at the end of 2018 and some new deals also have launched. The pricing and terms of these syndications to date in January have been mixed.

Take advantage of our Annual Leveraged Lending Market Update Webinar to Learn More

Thank you to our private equity clients who joined the Leveraged Lending Market Update webinar that the Weil finance team hosted on Monday January 28, 2019. For those who were unable to join, the webinar can be accessed on demand here. (passcode: weilwebinar). For more details regarding the webinar, please contact Kristen Zadourian at kristen.zadourian@weil.com or +1 212 735 4571.

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ENDNOTES

[i] GoldSheets Vol. XXXII, No. 49, Thomson Reuters LPC (December 17, 2018).
[ii] GoldSheets Vol. XXXIII, No. 1, Thomson Reuters LPC (January 7, 2019).
[iii] Ruth Yang, *Cov-lite in context: The structure's rise, by the numbers*, S&P Global Market Intelligence (December 12, 2018).
[iv] Press Release, Federal Reserve Issues FOMC Statement, Board of Governors of the Federal Reserve System (January 30, 2019).

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