S&P Global Market Intelligence

LCD Loan Primer

Syndicated Loans: The Market and the Mechanics

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

Since the leveraged buyout (LBO) boom of the mid-1980s in the U.S., the syndicated loan market has become the dominant way for issuers around the world 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.

In the syndicated loan world, 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 non-bank term loan investors (that rate is typically LIBOR+200 or higher, though this threshold moves up and down, depending on market conditions).

By contrast, large, high quality (investment grade) companies pay little or no fee for a plain vanilla loan, typically an unsecured revolving credit 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 transactions are much more complicated—and theoretically more risky—meaning they can be more lucrative for arrangers. A new leveraged loan can carry an arranger fee of 1% to 5% of the total loan commitment, depending on the complexity of the transaction, the strength of market conditions, and whether the loan is underwritten.

The more complex the transaction and situation, the higher the fee. Thus, merger-and-acquisition (M&A) and recapitalization loans will likely carry high fees, as will bankruptcy exit financings and restructuring deals for struggling issuers. Seasoned leveraged borrowers, in contrast, pay lower fees for refinancings and transactions where the debt is simply an add-on to an existing credit.

Because investment grade loans are infrequently drawn down, and therefore offer drastically lower yields, the ancillary business is as

Contents

Leveraged Commentary & Data (LCD) is the world's leading provider of leveraged loan news, analytics, and index products. Our award-winning news and research also span the high-yield and investment-grade bond markets.

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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 such as mutual funds, CLOs, hedge funds, and pension funds. Before formally launching a loan to these retail accounts, arrangers will often “read” the market 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 be attractive enough for investors.

Before 1998, that would have been the full extent of deal pricing. Once the spread and fee were set, they would not change, except in the most extreme cases. As a result, if the loan were undersubscribed, the arrangers could very well be left above their desired hold level.

After the Russian debt crisis roiled the market in 1998, however, arrangers adopted market flex language to make loans more attractive to investors by raising the spread or lowering the price during difficult syndication processes in volatile markets. Over time, however, market flex became a tool to either increase or decrease pricing of a loan based on investor demand.

Market flex allows arrangers to change the pricing of the loan—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 syndication process, at least in the leveraged arena, into a full-fledged capital markets exercise. It became even more important as the leveraged loan secondary continued to grow, as flex allowed the market to adjust deal pricing to appropriate levels in the primary market, reducing instances of major price fluctuation once a credit frees to trade.

Because of market flex, the syndication of a loan today functions as a “book-building” exercise, in bond-market parlance. Specifically, a loan is originally launched to market at a target spread or with a range of spreads referred to as “price talk” (e.g., a target spread of 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, or “print,” the loan. Following the example above, if the paper is oversubscribed at LIBOR+250, the arranger may reduce the spread further. Conversely, if it is undersubscribed even at LIBOR+275, the arranger may be forced to raise the spread to attract additional investor interest.

Sponsorship

Many leveraged companies are owned by one or more private equity firms. These firms, such as KKR, Carlyle Group, or Silver Lake, 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 can therefore be priced lower. In contrast, if the sponsor group does not have a loyal set of relationship lenders—or has a reputation for aggressive financial behavior—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, weight 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.

The core of European leveraged lending comes from borrowers owned by private equity funds, although “leveraged corporates” are becoming more popular as companies increasingly turn to the capital markets for financing via leveraged loans or high-yield bonds.

Debt and the auction process

Leveraged loan transactions originate well before lenders see the terms. In an LBO, the company is first put up for auction. A company that is up for sale to private equity sponsors for the first time is a primary LBO. A secondary LBO (and tertiary LBO) is a sale from one sponsor to another sponsor.

As prospective acquirers evaluate target companies, they also line up debt financing. A staple financing—usually a package arranged by the bank or investment bank advising the seller—may be on offer as part of the sale process. By the time the auction winner is announced, that acquirer usually has funds lined up via its designated mandated lead arrangers (MLAs). Where the loan is not part of a competitive auction, a sponsor usually solicits bids from arrangers before awarding a mandate. The competing banks will outline their syndication strategy and qualifications, as well as their view on the way the loan will price in the market.

What are loans used for?

For the most part, issuers use leveraged loan proceeds for four purposes: (1) to support a merger- or acquisition-related transaction (M&A), (2) to back a recapitalization of a company's balance sheet, (3) to refinance debt, and (4) to fund general corporate purposes.

Mergers and acquisitions

Historically, M&A has been the lifeblood of leveraged finance. There are three primary types of acquisition loans:

Leveraged buyouts. Most LBOs are backed by a private equity firm, which funds the transaction with a significant amount of debt in the form of leveraged loans, mezzanine finance, high-yield bonds, and/or seller notes. Debt as a share of total sources of funding for the LBO can range from 50% to upwards of 75%. The nature of the transaction will determine how highly it is leveraged.

Issuers with large, stable cash flows generally can support higher leverage. Similarly, issuers in defensive, less-cyclical sectors are given more latitude than those in cyclical industry segments. Finally, the reputation of the private equity backer (sponsor) plays a role, as does market liquidity (the amount of institutional investor cash available). Stronger markets usually allow for higher leverage.

There are three main types of LBO deals:

- **Public-to-private (P2P)**—also called go-private deals—in which the private equity firm purchases a publicly traded company via a tender offer. In some P2P deals, a stub portion of the equity continues to trade on an exchange. In others, the company is bought outright. This is the best-known type of LBO, with RJR Nabisco as its very famous poster child.

- **Sponsor-to-sponsor (S2S)** deals, where one private equity firm sells a portfolio property to another.

- **Noncore acquisitions**, in which a corporate issuer sells a division to a private equity firm.

Platform acquisitions. These are transactions in which private-equity-backed issuers buy a business that they believe will be accretive by either creating cost savings and/or generating expansion synergies.

Strategic acquisitions. These are undertaken by non-private-equity-related borrowers. Strategic acquirers are usually corporations in the same or a related industry segment as the target company, allowing the buyer to leverage its familiarity/expertise in the segment.

Recapitalizations

A leveraged loan backing a recapitalization results in changes in the composition of an entity's balance sheet mix between debt and equity either by 1) issuing debt to pay a dividend or repurchase stock, or 2) selling new equity, in some cases to repay debt.

Some common examples of recapitalizations:

- **Dividend**. Dividend financing is straightforward. A company takes on debt and uses proceeds to pay a dividend to shareholders. Activity here tends to track market conditions. Bull markets inspire more dividend deals as issuers tap excess liquidity to pay out equityholders using debt. In bearish markets, dividend activity slows as lenders tighten the reins, and usually look skeptically at transactions that weaken an issuer's balance sheet, from the credit perspective.

- **Stock repurchase**. In this form of recap deal a company uses debt proceeds to repurchase stock. The effect on the balance sheet is the same as a dividend, with the mix shifting toward debt.

- **Equity infusion**. These transactions typically are seen in distressed situations. In some cases, the private equity owners agree to make an equity infusion in the company, in exchange for a new debt package. In others, a new investor steps in to provide fresh capital. Either way, the deal strengthens the company's balance sheet.

- **IPO**. An issuer lists—or, in the case of a P2P LBO, relists—on an exchange. A portion of the equity proceeds of the listing are typically used to repay some debt, effectively deleveraging the company, usually resulting in an upgrade by ratings agencies. This, in turn, means the company often can issue new loans or bonds at more favorable terms (often called a post-IPO refinancing).

Refinancing

A new loan or bond is issued to refinance existing debt.

General corporate purposes and build-outs

These deals support working capital, general operations, and other business-as-usual purposes. Build-out financing supports a particular project, such as a utility plant, a land development deal, a casino, or an energy pipeline.

Loan investors

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

Banks

In this case, the term "bank" can refer to commercial banks, savings and loan institutions, or securities firms that usually provide investment grade loans. These deals are typically large revolving credits that back commercial paper or are used for general corporate purposes or, in some cases, acquisitions. For leveraged loans, banks typically provide unfunded revolving credits, LOCs, and—although they are becoming less common—amortizing term loans (typically called a term loan A or TLA), under a syndicated loan agreement.

Finance companies

Finance companies exist almost exclusively in the U.S. where they consistently represent less than 10% of the leveraged loan market. They borrow money to fund their loans, and tend to play in smaller deals—$25 million to $200 million. These investors often seek asset-based loans (ABLs) that carry wide spreads, and that often feature time-intensive collateral monitoring. However, they have failed to materialize in Europe because ABL lending is scarce there.

Institutional investors

Institutional investors are principally structured vehicles known as collateralized loan obligations (CLOs) and some form of a pooled loan fund, either a mutual/prime fund or a privately managed credit fund.

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 triple-A rated tranche, a double-A tranche, a triple-B 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 that 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. Market value CLOs are less leveraged—typically three to five times—which allows 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.

Loan mutual funds invest in leveraged loans, enabling retail investors—individuals—to access the loan market. In the U.S., the primary form is a mutual fund or prime fund (because they were originally pitched to investors as a money-market-like fund that would approximate the prime rate).

In Europe, UCITS (undertakings for collective investment in transferable securities) regulations restrict the marketing of loans directly to retail investors, so these types of funds do not exist in Europe. However, managed accounts, privately managed separate credit funds, have become increasingly popular in Europe and the U.S., and represent a growing share of the investor market. In addition, in both regions, hedge funds, high-yield bond funds, pension funds, insurance companies, and other proprietary investors do participate opportunistically in loans, usually focusing on wide-margin paper. Fund managers oversee a wide variety of accounts, and loan investment strategies are increasingly global in nature, as investors look for relative value, especially in low-rate environments.

Today there are four main categories of funds.

- **Continuously offered, closed-end funds** were the first loan mutual fund products. Investors can buy into these funds each day at the fund's net asset value (NAV). Redemptions, however, are made via monthly or quarterly tenders rather than each day. To ensure they can meet redemptions, many of these funds, as well as daily-access funds, set up lines of credit to cover withdrawals above and beyond cash reserves.

- **Exchange-traded, closed-end funds (ETFs)** are funds that trade on a stock exchange. Typically, the funds are capitalized by an initial public offering. Thereafter, investors can buy and sell shares, but may not redeem them. The manager can also expand the fund via rights offerings, but usually, they are only able to do so when the fund is trading at a premium to NAV—a provision that is typical of closed-end funds regardless of the asset class.

- **Daily-access funds** are traditional open-end mutual fund products into which investors can buy or redeem shares each day at the fund's NAV.

- **Managed accounts** are separately managed investment accounts tailored to the particular requirements of the investor.

European investors

The European investor base traditionally has been narrower than that in the U.S., with most funding provided by banks, CLOs, credit opportunity funds, and mezzanine accounts. In the European retail/investor market, banks remain influential, especially in certain regions, such as the Nordic region. This is due, historically, to Europe's intrinsically regional nature, where banks have had greater familiarity with regional issuers and could fund in the local currency.

But since the eurozone was formed in 1998, the growth and centralization of the European leveraged loan market has been fueled by the efficiency provided by this single currency, as well as an overall growth in M&A deals, particularly LBOs due to private equity activity. Regional barriers (and sensitivities toward consolidation across borders) have fallen, economies have grown, and the euro has helped to bridge currency gaps. This has given institutional investors a much greater role in the syndication market through avenues such as structured vehicles, various credit fund strategies, and separately managed accounts. Market participants estimate that two-thirds of current market demand comes from non-bank investors.

European credit funds are open-ended pools of debt investments. Unlike CLOs, however, they are not subject to ratings oversight or restrictions regarding industry or rating diversification. They are generally lightly levered (two to three times) and allow managers significant freedom in picking and choosing investments. They are subject to mark-to-market standards.

Mezzanine funds are investment pools that traditionally have focused on the mezzanine market only, providing subordinated debt for buyouts before the high-yield bond market was active and liquid in Europe. As high-yield bond financing became widely used in the run-up to the 2008 financial crisis, many mezzanine lenders were crowded out, and had to either settle for lower-yielding second-lien tranches, or combine debt investments with equity investments to boost returns. As with credit funds, these pools are not subject to ratings oversight or diversification requirements, and allow managers significant freedom in picking and choosing investments. Since the 2008 financial crisis, many of these funds have been wound down or diversified into direct lending or other strategies. Increasingly, direct lending funds have taken their place in providing subordinated capital—or a combination of subordinated and senior debt via a unitranche—particularly for smaller transactions.

Direct lenders: The European direct lending market has developed rapidly since 2014, with dozens of new managers setting up, including a number of private equity firms that have set up their own lending operations. The market is top-heavy, with the largest five or so managers executing many more direct transactions than the plethora of smaller players. Growth has been fueled by institutional investors switching portions of their fixed income allocations into more illiquid but higher-yielding private debt strategies. Managers take a variety of different approaches to the strategy with specializations ranging from the lower middle market to more 'storied' credits. The largest of Europe's direct lenders have raised multi-billion euro pools of capital for the strategy. Most large and mid-sized direct lenders concentrate on unitranche financings, or bullet loans with an extra half to one turn of leverage paying anything from 6.5% to 11%. They are called unitranche because they are provided by a single lender, but are often sliced up behind the scenes.

Public versus private

In the early days of the market, a bright red line separated public and private information. 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 (1) to support 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 yet parties to the loans.

The second innovation that weakened the public/private divide was trade journalism that focused on the loan market as the asset class continued to grow.

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 a number of factors, including the proliferation of loan ratings, the explosive growth of non-bank investor groups, the growth of the credit default swaps market, 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 U.S. issuers with public equity or debt, and which file with the U.S. Securities & Exchange Commission (SEC), the credit agreement only becomes public when it is filed, often months 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.

Increasingly, this information has leaked into the public domain via either off-line conversations or the press. It has also come to light through mark-to-market pricing services, which from time to time 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.

There has been 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. The various players in the market have contended with these issues in different ways:

- **Traders**. To insulate themselves from violating regulations, some dealers and buyside 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**. 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.

- **Buyside accounts**. On the buyside, accounts that operate on the private side receive all confidential materials and agree to not trade in public securities of the issuers in question. These groups are often part of wider investment complexes, but are sealed from the parts of the firms that have public funds and portfolios. Some accounts are fully on the public side. 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—in the case of an amendment, the lender could be called on to approve or decline in the absence of any real information. 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 a price change reported by a mark-to-market service.

Another way in which participants in general deal with the public-versus-private issue is to ask counterparties to sign "big boy" letters. These letters typically ask public-side institutions to acknowledge 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.

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 CLOs, mutual funds, and insurance companies). As such, leveraged loans consist of the following types of debt:

Institutional debt includes term loans structured specifically for institutional investors, though there are some banks that buy institutional term loans. These tranches include first- and second-lien loans.

Traditionally, institutional tranches were referred to as TLBs because they were bullet payments and lined up behind TLAs (term loans that amortize). In Europe, this terminology is still prevalent.

Pro rata debt includes revolving credit and amortizing term loans, 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 allocation.

Why are these tranches called pro rata? Because arrangers historically have syndicated revolving credit and TLAs together, to be distributed on a proportional basis to banks and finance companies.

Finance companies buy both pro rata and institutional tranches. With institutional investors playing an ever-larger role, however, by the late 2000s, many executions were structured as simply revolving credit/institutional term loans, with the TLA falling by the wayside. After the 2008/2009 financial crisis, Europe followed a similar pattern, with TLAs becoming increasingly rare.

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 just spread income. Rather, banks are driven by the overall profitability of the issuer relationship, including non-credit 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, return on economic capital, or some other metric.

If a bank is going to put a loan on its balance sheet, it takes a hard look not only at the loan's yield, but also at other sources of revenue from the relationship, including non-credit businesses—like cash-management services and pension-fund management—and economics from other capital markets activities—like bonds, equities, or M&A advisory work.

The spread offered to pro rata investors is important, but so too, 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 historically have been 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 they are focused not on a basket of returns, 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 (supply and demand).

Liquidity is the tricky part. But, as in most markets, all else being equal, more liquid instruments command thinner spreads than less liquid ones. In the old days—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. Of course, once a loan gets large enough to demand extremely broad distribution, the issuer usually must pay a size premium. The thresholds range widely. During the hyper-liquid years before the 2008/2009 financial crisis, it was upwards of $10 billion. During the more parsimonious years that followed, $1 billion was considered a stretch.

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

The mark-to-market effect

Beginning in 2000, the SEC directed bank loan mutual fund managers to use available price data (bid/ask levels reported by dealer desks and compiled by mark-to-market services) rather than fair value (estimates based on whether the loan is likely to repay lenders in whole or in part), to determine the value of broadly syndicated loan portfolios. 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.

Credit risk: Where the rubber hits the road

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, collateral coverage, seniority, credit statistics, industry sector trends, management strength, sponsor behavior, and location (transactions in Europe have different factors than in the U.S.). All of these, together, tell a story about the deal.

Default risk is simply the likelihood of a borrower 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, as well as economic variables and intangibles, such as company management. Default risk will, in most cases, be most visibly expressed by a public rating from S&P Global Ratings or another ratings agency. These ratings range from AAA for the most creditworthy loans to CCC for the least. The market is roughly divided into two segments: investment grade (issuers rated BBB– or higher) and leveraged, or speculative grade (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 do business with a wide group of 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-2017, some 90% of loans issued in the U.S. loan market were rated. Meanwhile, in Europe, according to the ELLI index, some 72% of loans issued were publicly rated.

Seniority is where an instrument ranks in priority of payment. An issuer will direct payments with the senior-most creditors paid first and the most junior equityholders last. In a typical structure, senior secured and unsecured creditors will be first in right of payment—although in bankruptcy, secured instruments typically move to the front of the line—followed by subordinated bondholders, junior bondholders, preferred shareholders, and common shareholders. Leveraged loans are typically senior secured instruments and rank highest in the capital structure— although post crisis, super senior revolving credit facilities have appeared in capital structures, which rank ahead of the secured term loans.

Loss-given-default risk (LGD) measures the severity of loss the lender is likely to 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 (sometimes this is also referred to as "recovery risk"). Lenders will also look to financial 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 usually senior secured instruments and some include maintenance covenants. Under these covenants, issuers must comply with pre-set financial tests on a quarterly basis. 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 are used by investors to help calibrate both default and loss-given-default risk. These stats 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 projections and the assumptions behind these projections to see if the issuer's game plan will allow it to service debt. There are ratios that are most geared to assessing default risk, including leverage and cash-flow or interest coverage. Then there are ratios that are suited for evaluating loss-given-default risk, including collateral coverage, or the value of the collateral underlying the loan relative to the size of the loan. They also include the ratio of the 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 it does when the loan constitutes a greater percentage of the overall debt structure. 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 is a factor because sectors, naturally, go in and out of favor (traditional retail in the age of Amazon, for instance). 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, loans to issuers in defensive sectors (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.

Historically, the European market has been less transparent because public ratings were not commonly required to get a deal syndicated. This was a by-product of the bank investor market,

Arrangers and 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 long been largely ceremonial, 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 an old-time 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 syndication process are administrative agent, syndication agent, documentation agent, agent, co-agent or managing agent, and lead arranger or bookrunner.

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 indicates 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 **bookrunner** title is a league table designation used to indicate the “top dog” in a syndication.

European lender titles reflect either the banks’ positions in the arrangement and underwriting of the transaction or their administrative roles. The **mandating lead arranger** (MLA) designation remains the most significant lender title for the bank (or banks) providing the primary arrangement and initial underwriting, and receiving the majority of fees. As the loan market has grown and matured, the array of “co-agent” titles has proliferated. The primary administrative title is that of bookrunner (or joint bookrunner when there is more than one bank involved). The bookrunner role is almost always assigned to the MLA(s) and it takes on the administrative tasks generally associated with the administrative agent and syndication in the U.S. The other administrative titles seen regularly in the European market are the **facility agent** and **security agent**. The co-agents are designated during the sub-underwriting phase. The primary co-agent title is joint lead arranger (JLA). The JLAs make the largest underwriting commitments and, in turn, receive the largest fees. Co-agent titles assigned during general syndication include arranger, co-arranger, and lead manager. These co-agent titles have become largely ceremonial, routinely awarded for what amounts to no more than large retail commitments in exchange for upfront fees.

as well as the strong relationship that existed between lenders and sponsors. Investors relied on their own understanding of default risk and their own assessment of the credit, rather than relying on independent credit analysis. CLO managers who needed ratings on the credits they invested in, to comply with their internal tests, could obtain private “credit estimates” from ratings agencies, rather than full public ratings. However, after the 2008/2009 financial crisis the European market’s approach to public credit ratings has changed, and the share of public ratings has steadily increased. This happened for two reasons.

First, when the loan markets became less liquid after the crisis, many borrowers turned instead to the public high-yield bond market to refinance facilities (using senior secured bonds), for which the investor market requires public ratings. Second, ratings agencies changed their methodology. For example, S&P Global Ratings refused to provide credit estimates for loans of above a certain size. If a borrower needed its rating to remain private, the ratings agency could assign a private rating, allowing the borrower to keep the credit information within a closed lender group.

Default and recovery risk is harder to quantify in Europe than in the U.S. because distressed transactions tend to privately restructure rather than publicly default. U.S. bankruptcy courts are more transparent, with a focus on restructuring versus liquidation. In Europe, parties are subject to the vagaries of the array of bankruptcy regimes, and thus are more likely to come to a private restructuring. The influence and support provided by sponsors in these events cannot be underestimated.

The Shapes, Sizes, and Formats of Loans

The loan market is unique in that it can flex, bend, shape and warp itself on the fly to match the needs of borrowers with the requirements of lenders. The ability to customize these transactions to current market dynamics and requirements is reflected in the multitude of formats the loan financing can take.

As mentioned earlier, a syndicated loan is a commercial credit provided by, or syndicated amongst, a group of lenders. When a bank undertakes the process of arranging the loan and finding lenders, this is called the syndication. There are three types of syndications: an underwritten deal, a best efforts syndication, and a club deal.

On **underwritten deals**, arrangers guarantee the entire commitment, then syndicate the loan. This is a strategy some banks use as a competitive tool to win mandates and earn lucrative fees. The downside for the arranger: if there is not investor interest to fully subscribe the loan, the arrangers are forced to absorb the difference, which they may later try to sell to investors.

This is achievable, in most cases, 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 (known as "selling through fees"). Or the arranger may just be left above its desired hold level of the credit. 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).

In a **"best efforts" syndication** 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 have been used for risky borrowers or for complex transactions.

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.

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 memorandum (IM) describing the terms of the transaction. 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 non-bank 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. 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 their appetite for the deal and the price at which they are willing to invest. Once this intelligence has been gathered, the agent will formally market the deal to potential investors.

The bank book

The IM typically contains the following sections:

- The **executive summary** includes a description of the issuer, an overview of the transaction and rationale, sources and uses of the debt being raised, and key statistics on the financials.

- The **investment considerations section** is basically management's sales pitch for the deal.

- The **list of terms and conditions** is 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** is a description of the company's industry and competitive position relative to its industry peers.

- The **financial model** is 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 kick off at a bank meeting at which potential lenders hear management and the sponsor group (if there is one) describe the terms of the loan and the transaction it supports. Most bank meetings are conducted virtually, although some issuers still prefer old-fashioned, in-person gatherings; in Europe, in fact, apart from drive-by repricings, most bank meetings are still in person.

Whatever the format, management uses the bank meeting to provide its vision for the transaction and, most importantly, to 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. 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. In liquid market conditions, a common amendment is one that allows the borrower to reprice facilities.

Terms and conditions

The terms and conditions (T&Cs) outline the basic rules by which the loan will function. They include the covenants, mandatory prepayments, and other conditions that the borrower must meet in order to be current and healthy on its obligations.

The terms and conditions set out under the bank book are subject to change during the syndication process, and are finalized in the credit agreement.

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 and other protective loan provisions

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 shakier 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 maximum amount of the loan that the issuer may draw down capped by a formula based off of these assets. The common rule is that an issuer can borrow against 50% of inventory and 80% of receivables. There are loans backed by certain equipment, real estate, and other property as well.

In the leveraged market, some loans 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 subsidiaries and their assets 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.

Subsidiary guarantees are not collateral in the strict sense of the word. However, most leveraged loans are backed by subsidiary guarantees so that if an issuer goes into bankruptcy all of its units are on the hook to repay the loan. This is often the case, too, for unsecured investment grade loans.

A negative pledge is also not a literal form of collateral, but most issuers agree not to pledge any assets to new lenders to ensure that the interests of the loanholders are protected.

Springing liens/collateral release requirements are primarily attached to borrowers on the cusp of investment grade versus

Covenants

Loan agreements include restrictions regarding how borrowers can operate and carry themselves financially. One covenant may require the borrower to maintain its existing fiscal year end, while another may prohibit it from taking on new debt. Most agreements also have financial compliance covenants. For example, if a borrower doesn't maintain a prescribed level of performance, banks have 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 simple; those to leveraged borrowers are more restrictive. The 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. These covenants are usually boilerplate and require a borrower to, for example, pay the bank interest and fees, provide audited financial statements, maintain insurance, pay taxes, and so forth.

- **Negative covenants**, which are highly structured and customized to a borrower's specific condition, can limit the borrower's activities, such as its acquisitions and investments, new debt issuance, liens, asset sales, and guarantees. Many negative covenants are structured with baskets allowing issuers flexibility to take certain actions, such as dividend payments or acquisitions, as long as the amounts involved are within a set range. The agreement may provide initial capacity, known as a starter basket, as well as additional capacity based on a percent of free cash flow or net income, known as a building basket.

- **Financial covenants** enforce minimum financial performance measures against the borrower, e.g., that it maintain a higher level of current assets than liabilities. Broadly speaking, the two types of financial covenants are maintenance and incurrence. Under maintenance covenants, issuers must pass tests of financial performance such as minimum levels of cash flow coverage and maximum levels of leverage. If an issuer fails to achieve these levels, lenders have the right to accelerate the loan. In most cases, lenders will pass on this option (it may result in a lower post-default recovery) and instead grant a waiver in return for a combination of a fee and/or spread increase, a repayment, or a structuring concession such as additional collateral or seniority. An incurrence covenant is tested only if an issuer takes an action, such as issuing debt or making an acquisition. If, on a pro forma basis, the issuer fails the test, then it's not allowed to proceed without lender permission.

Historically, maintenance tests were associated with leveraged loans and incurrence tests with investment grade loans and bonds. More recently, the evolution of covenant-lite loans has blurred the line. In a traditional loan agreement, as a borrower's risk increases, financial covenants 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), and 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 total-debt-to-EBITDA level being the most common. In some cases, though, operating cash flow is used as the divisor. Moreover, some agreements test leverage on the basis of net debt (total less cash and equivalents) or senior debt.

- 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 numerate, 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, plants, 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.

speculative grade. This language states that the borrower must attach or release collateral if the issuers' ratings change.

Issuers rated BBB or BBB– 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 attains an investment grade rating.

An issuer may divide a collateral pledge between asset-based loans and funded term loans. This is called a **bifurcated collateral structure**. The way this works, typically, is that asset-based loans are secured by current assets like accounts receivable and inventories, while term loans are secured by fixed assets like property, plants, and equipment. Current assets are considered to be a superior form of collateral because they are more easily converted to cash.

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-lenders 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 loan repayments and release of collateral.

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.

Equity cures

These provisions allow issuers to fix a covenant violation—exceeding the maximum leverage test for instance—by making an equity contribution. These provisions are generally found in private-equity-backed deals. The equity cure is a right, not an obligation. Therefore, a private equity firm will want these provisions, which, if they think it's worth it, allow them to cure a violation without going through an amendment process, through which lenders will often ask for wider spreads and/or fees in exchange for waiving the violation even with an infusion of new equity. Some agreements don't limit the number of equity cures while others cap the number to, say, one a year, or two over the life of the loan. It's a negotiated point, however, so there is no rule of thumb.

Intercreditor agreements and cross-guarantees

European borrowers tend to have more complex corporate structures than U.S. firms due to the multijurisdictional nature of the eurozone, as well as the prevalence of private equity management. As a result, intercreditor agreements and cross-guarantees are significant parts of ensuring lender rights regarding a loan transaction, particularly concerning underperformance or default. The intercreditor agreement is an agreement to subordination and stipulates the priority of repayment to all lenders, senior and subordinated, in the case of default. It applies to lenders across borders and codifies their positions in the absence of intervention from individual bankruptcy courts.

Similarly, cross-guarantees ensure that the varied operating units associated with a borrower guarantee its assets as collateral. Thus, should one part trigger a default, all the associated companies will be equally responsible and their assets will be available for repayment.

The fixed and floating liens are another type of guarantee from operating units of the borrower. This type of guarantee balances the need of the borrower to have the ability to actively manage its business with regards to acquiring and disposing of assets, with that of the lender to have claim to those assets in the case of underperformance or default. The terms of this guarantee essentially allow the borrower to dispose of assets without consent (thus the floating aspect). However, the proceeds must go through certain channels, including certain designated accounts, so that the borrower has the right to freeze those assets (fixing them) under certain circumstances.

Financials

The bank book also contains sections on the company's historic and projected financials to help demonstrate the company's financial performance and the key assumptions the new private equity owners are making to demonstrate the company's ability to repay its lenders. Historical financials will include actual sales and EBITDA figures from the past four to five years, as well as profitability metrics, such as gross profit margin, net margin, and EBITDA margin. For specific industries there may be other financial metrics. For example, compound annual growth rate (CAGR) may be used for retail stores.

There is also typically information on capex spend (both growth and maintenance capex) and cash flow metrics, such as operating cash flow or free operating cash flow. This section is usually followed by an update on current trading for these measures in the current fiscal year. Then the company will show its forecasts for these same types of metrics, usually projecting out at least five years, if not six or seven, and its forecasts for whatever it considers to be its key credit metrics. These can include net leverage (debt-to-EBITDA), cash interest cover (EBITDA/cash interest expense), and debt service coverage ratio, or DSCR (cash flow pre-financing/cash interest + amortization). The bank books show through these financial projections how the company's top-line growth will allow it to deleverage over time and repay lenders.

Types of syndicated loan facilities

Traditionally, the four main types of syndicated loan facilities are (1) revolving debt, (2) term debt, (3) letter of credit (LOC) and (4) acquisition or equipment line (a delayed-draw term loan). However, over the last twenty years, the market has innovated upon these formats, resulting in an array of permutations, including second-lien, covenant-lite, and cross-border transactions.

A **revolving credit** allows borrowers to draw down, repay, and reborrow. The facility acts much like a corporate credit card, except that borrowers are charged an annual fee on unused amounts (the facility fee). Revolvers to speculative grade issuers are sometimes tied to borrowing-base formulas. These limit borrowings to a certain percentage of specified 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. Banks, therefore, can offer issuers 364-day facilities at a lower unused fee than on 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** allows the borrower to borrow in one or more alternative currencies (in most agreements this option is capped).

- A **competitive-bid option** (CBO) allows the borrower 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 revolving borrowings into a term loan at a given 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. For instance, at the end of each year, a three-year facility would be reset to three years if the lenders and borrower agree. If the evergreen is not exercised, the agreement would simply run to term.

A **term loan** is 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 (during which lenders usually share a ticking fee, akin to a commitment fee on a revolver) and repay 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 loan 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.

- An **institutional term loan** (TLB, TLC, TLD, etc.) is a term loan facility carved out for non-bank investors. These loans came into broad usage during the mid-1990s as the institutional loan investor base grew. This institutional category also includes second-lien loans and covenant-lite loans.

LOCs (letters of credit) 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.

Bridge loans are loans that are intended to provide short-term financing to provide a “bridge” to an asset sale, bond offering, stock offering, divestiture, etc. Generally, bridge loans are provided by arrangers as part of an overall financing package. Typically, the issuer will agree to increasing interest rates if the loan is not repaid as expected. For example, a loan could start at a spread of L+250 and ratchet up 50 basis points (bps) every six months the loan remains outstanding past one year.

An **equity bridge loan** is a bridge loan provided by arrangers that is expected to be repaid by a secondary equity commitment to a leveraged buyout. This product is used when a private equity firm wants to close on a deal that requires, say, $1 billion of equity of which it ultimately wants to hold half. The arrangers bridge the additional $500 million, which would be then repaid when other sponsors come into the deal to take the $500 million of additional equity. Needless to say, this is a hot-market product. In Europe, these type of facilities are called subscription-line financing.

Second-lien loans are really just another type of syndicated loan facility. However, they are sufficiently complex to warrant a separate section in this space. After a brief flirtation with second-lien loans in the mid-1990s, these facilities fell out of favor when the 1998 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 2007 the market had accepted second-lien loans to finance a wide array of transactions, including acquisitions and recapitalizations. Arrangers tap non-traditional accounts—hedge funds, distressed investors, and high-yield accounts—as well as traditional CLO and prime fund accounts to finance second-lien loans. In Europe, however, the historical dynamics are slightly different, with second-liens providing an additional tranche of debt between senior secured loans and more subordinated debt—either mezzanine financing or high-yield bonds.

As their name implies, the claims on collateral of second-lien loans are junior to those of first-lien loans. Second-liens also typically have less restrictive covenant packages, in which maintenance covenant levels are set wide of the first-lien loans. For these reasons, second-liens are priced at a premium to first-lien loans. This premium typically starts at 200 bps 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 to the first-lien claims, and next to the second-lien claims.

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 discrete security agreements, divided by a standstill agreement, the first- and second-lien lenders are likely to be divided into two creditor classes. 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.

Unlike in the U.S., where second-lien loans typically have less restrictive covenant packages in which maintenance covenant levels are set wider than the first-lien loans, European second-lien credits share the same covenant package as first-lien facilities.

Covenant-lite loans are another variation on the syndicated loan facility. At the most basic level, covenant-lite loans are loans that have bond-like financial incurrence covenants rather than the 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, 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 a lender, maintenance tests are preferable because they allow the lender 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.

Free-and-clear incremental tranches are carve-outs in covenant-lite loans that allow borrowers to issue debt without triggering incurrence financial tests. For instance, a leverage test may say that an issuer cannot take on new debt if, on a pro forma basis, total debt to EBITDA would be 4x or more—but the test only kicks in once the issuer incurs more than, say, $100 million of new debt. That effectively gives the borrower the ability to issue up to $100 million of new debt at a market clearing rate whether or not leverage exceeds 4x.

Lenders, in most cases, have most-favored-nations (MFN) protection that resets the yield of the existing loan to the rate of the new loan to make sure it remains on market. In what used to be rare cases, however, this protection is limited to a certain period of time by what is known as an MFN sunset (in issuer-friendly markets, MFN sunsets have proliferated). In other cases, the rate adjustment is capped to say, 50 bps. Free-and-clear tranches are an innovation that has grown with the proliferation of covenant-lite loans since 2013. Lenders expect the use of these provisions to ebb and flow with the strength of market conditions.

Cross-border loans are transactions that are syndicated simultaneously into multiple markets. The most common cross-border transaction is one that is sold to both U.S. and European investors. However, cross-borders can also be transactions sold in Asia and the U.S., Asia and Europe, or even Asia, the U.S., and Europe.

The tranches that make up a cross-border loan are denominated in currencies to match the markets that they are being sold to. Thus, the U.S. portion of a cross-border loan will be denominated in U.S. dollars and the European portion will be denominated in euros and/or British pounds.

For a cross-border transaction to be viable, the issuer usually must have operations in all of the markets that it is selling debt to. For example, a company that traditionally issues in the U.S., such as HCA Inc., must also have assets and/or business in Europe to support a euro tranche sold to European investors.

Mezzanine loans were a standard feature of the European debt structure until the credit crunch of 2008/2009. A mezzanine loan is a subordinated instrument that carries second-ranking security (or third-ranking security if the capital structure also includes second-lien). Historically, mezzanine has been a financing option of choice for small transactions, while the high-yield bond market provided subordinated financing for large deals. Prior to 2008, mezzanine had extended its reach to include large deals, becoming a staple of LBO financings ranging in size from €10 million to €1 billion.

Mezzanine was popular with private equity groups because, unlike public high-yield bonds, it was a private instrument, syndicated to a group of lenders ranging from traditional shops that specialize in mezzanine to new investors, such as hedge funds. In addition to being subordinated debt, mezzanine included a number of unique features. The interest consisted of a cash and PIK margin above a base rate. Due to its secondary or tertiary position in the priority line, the total margin was considerably higher than on senior bank loans. In addition to spread, mezzanine traditionally included warrants to provide lenders an unlimited upside potential should the issuer perform well. All other things being equal, deals with warrants carry lower spreads than those without.

Mezzanine often had a non-call provision, for one to three years, plus prepayment penalties in the subsequent years. This also appealed to private equity groups because, when exiting a company, it was cheaper to repay mezzanine than high-yield bonds, which have longer non-call periods. This instrument carried the same financial covenants as senior bank loans. Some facilities had identical covenant levels as the first ranking debt while others include a "haircut," which refers to how much looser the mezzanine covenants were compared with senior debt. Usually this number was around 10%.

The standard mezzanine standstill periods are either 60/90/120 days or 90/120/150 days for mezzanine payment defaults/financial covenant defaults/other mezzanine defaults, respectively. The mezzanine market all but disappeared after the 2008/2009 credit crunch, and was largely replaced by the high-yield bond market and direct lending—and increasingly, second-lien paper, which at the moment is often placed privately with direct lenders.

Loan pricing

Loan pricing involves the interest, usually in the form of a spread over a base rate, and an array of fees, usually used to incentivize lenders to participate in a transaction or to agree to changes in terms and conditions.

Interest

The interest portion of loans involves a **base rate**, typically LIBOR or prime, and the additional spread. Base rates are the minimum rate which the loan will pay. Most loans are floating-rate instruments that are periodically reset to a spread over

Fees

The fees associated with syndicated loans are the upfront fee, the commitment fee, the facility fee, the administrative agent fee, the usage fee, the LOC fee, and the cancellation or prepayment fee.

An **upfront fee** is a fee paid by the issuer at close. It is often tiered, with the lead arranger receiving a larger amount in consideration for structuring and/or underwriting the loan. Co-underwriters will receive a lower fee, and then the general syndicate will likely have fees tied to its 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 at close. 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 competitive bid options 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 paid when the utilization of a revolving credit is above a set level or more often below a certain minimum.

A **prepayment fee** is a feature generally associated with institutional term loans. 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, including from asset sales and excess cash flow (a "hard" fee) or specifically to discretionary payments made from a refinancing or out of cash on hand (a "soft" fee).

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.

An **LOC fee** can be any one of several types. The most common—a fee for standby or financial LOCs—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 its 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 12.5–25 bps (0.125% to 0.25%) of the LOC commitment.

a base rate, typically LIBOR. In most cases, borrowers can lock in a given rate for one month to one year. Syndication pricing options include prime, LIBOR, CDs, and other base rate options.

With the **prime rate,** borrowed funds are priced at a spread over the reference bank's prime lending rate. The rate is reset daily, and borrowings 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.

The **LIBOR** (or Eurodollar) is also floating rate but, with this option, the base rate resets over longer periods—anywhere from one month to one year. Borrowings cannot be prepaid without penalty. **LIBOR floors** come into vogue as the base rate declines. As its name implies, the LIBOR floor puts a floor under the base rate for loans. If a loan has a 1% LIBOR floor and LIBOR falls below this level, the base rate for any resets defaults to 1%.

Other floating rate options exist, but are rare. The **CD** option works precisely like the LIBOR option, but the base rate is certificates of deposit, sold by a bank to institutional investors. There is also a **federal funds** option which is the overnight rate charged by the Federal Reserve to member banks, and **cost of funds**, which is the bank's own funding rate.

In European transactions, there are also **local currency options**, whereby facilities can fund in a number of currencies other than the euro, particularly the British pound and the U.S. dollar. U.S. dollar- and sterling-denominated tranches will generally use their respective LIBORs as the base rate. Tranches denominated in other local currencies, such as the Swiss franc or the Swedish krona, can float over a local money market base rate, but usually also provide a further option to fund in a more common currency, such as the euro or the U.S. dollar, and will thus use the relevant base rate.

In addition to the base rate, the borrower pays a specified **spread** or **margin** over the base rate to borrow under loan agreements. The spread is typically expressed in basis points.

Spreads on many loans are tied to performance grids. In this case, the spread adjusts based on one or more financial criteria. Ratings-based grids are typical in investment grade loans.

As discussed earlier in this primer (see "Pricing a loan in the primary market" section), spreads are set through the book-building process that includes reading the market dynamics and flexing pricing to drive demand for the loan.

Original-issue discounts (OIDs) are yet another term imported from the bond market. The OID, the discount from par at loan issuance, is offered in the new issue market as a spread enhancement. If a loan is issued at 99 cents on the dollar to pay par, the OID is technically 100 bps, or 1 point. Colloquially, the OID is often expressed as the actual offer price or issue price.

At this point, the careful reader may be wondering just what the difference is between an OID and an upfront fee. After all, in both cases the lender effectively pays less than par for a loan. From the perspective of the lender, there is no practical difference. From an accounting perspective, however, an OID and a fee may be recognized, and potentially taxed, differently.

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 50–65% 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." The bank lends against the receivables, takes possession of them, and then collects them 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.

The Post-Launch Life of a Loan

Once syndicated loans have launched, they continue on through the normal life cycle of any other financial instrument or security. They trade in the secondary market, and get repaid, refinanced, and sometimes, restructured.

Secondary sales

Leveraged loans are sold in the secondary market after the primary loan syndication is closed and the credit has been allocated. At that point 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.

There are two types of sales—assignments and participations.

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. In some cases, assignment fees were reduced or even eliminated for institutional assignments.

One market convention that became firmly established in the late 1990s was assignment-fee waivers by arrangers for trades crossed through their secondary trading desks. This was a way to encourage investors to trade with the arranger rather than with another dealer. This provided a significant incentive to trade with the arranger—or a deterrent to not trade away, depending on your perspective—because a $3,500 fee amounts to 7–35 bps of a $1 million to $5 million trade.

Primary assignments refer to primary commitments made by offshore accounts (principally CLOs and hedge funds). These vehicles, for a variety of reasons, suffer tax consequences 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 will sell it to these investors via an assignment. Though called primary assignments, they are effectively primary purchases.

In a **participation agreement** the buyer takes a participating interest in the selling 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). Non-material changes do not require approval of participants.

A participation can be a riskier way of purchasing a loan because, if the lender of record becomes insolvent or defaults, 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.

Prepayments/Non-call features

Since loans are floating-rate instruments, they carry the "free option" of being prepaid—or called—at any time without penalty. This is one reason why private equity firms often prefer loan to bond financing—because they can prepay or call a loan when it is advantageous to refinance at a better rate, make an add-on acquisition, recapitalize the business and pay themselves a dividend, or float the business publicly through an IPO.

There are cases, however, where prepayment fees do apply—although typically for syndicated loans these are considered "soft call" provisions, where fees are typically not more than 2% in year one and 1% in year two. In fact, the recent market standard soft call protection in both Europe and the U.S. is much more favorable for borrowers, typically consisting of only six-month call protection with a prepayment fee during that time of 1%.

Loan math—the art of spread calculation

Calculating loan yields or spreads is not straightforward. Unlike most bonds, which have long non-call periods and high call premiums, as previously explained, most loans are prepayable at any time typically without fees. 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 new financing. Traders and investors will often speak of loan spreads, therefore, as a spread to a theoretical call. Loans, on average, now assume a three- or four-year 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. Of course, if there's a LIBOR floor, the minimum would apply.

Amendments and waivers

During syndication and after the transaction has closed, all of the terms of a loan are subject to negotiation. Before the transaction closes, during the book-building process, arrangers revise terms to benefit borrowers but also ensure that enough lenders are willing to participate in the transaction.

After the loan closes, however, the borrower can ask for a change in terms via an amendment. Frequently the lenders will require some kind of compensation for those changes in the form of an amendment fee.

The typical amendment requests are for repricing, covenant relief, a waiver to one of the terms and conditions, and amend-to-extend.

An amendment to change the spread is a **repricing**. When these amendments occur, it is nearly always in a bull market where demand exceeds supply and the borrower is in the driver's seat. In these cases, the primary market spread on loans is declining because lenders forfeit spread in return for being able to stay invested when paper is scarce. In this situation, borrowers already in the market will ask the lenders to allow them to reduce the existing spread on the loans. Basically, the borrowers have the lenders over a barrel, and the repricing occurs because that way the lenders can remain in the deal but at the current market price.

A **covenant relief** amendment occurs when the borrower is in danger of breaching a covenant (in most cases financial). If a borrower knows that it cannot meet its upcoming financial covenant test, they will ask the lenders to waive or amend the covenant so that the borrower is not in breach. In return, the lenders receive a fee.

The borrower may also ask the lenders for a **waiver** of one of the terms and conditions. For example, if a borrower sells an asset, which would normally be subject to prepayment conditions, they may ask for a waiver in order to use those funds for a different purpose. Alternately, the borrower may be changing the structure of the company due to an acquisition or sale, and they may ask for a waiver of the change-of-control clause. In most of these cases, the borrower will need to pay a fee to the lenders for the waiver.

An **amend-to-extend** transaction allows an issuer to push out part of its loan maturities through an amendment, rather than a full-out refinancing. Amend-to-extend transactions came into widespread use in 2009 as borrowers struggled to push out maturities in the face of difficult lending conditions that made refinancing prohibitively expensive.

Amend-to-extend transactions have two phases, as the name implies. The first is an amendment in which at least 50.1% of the bank group must approve the issuer's ability to roll some or all existing loans into longer-dated paper. Typically, the amendment sets a range for the amount that can be tendered via the new facility, as well as the spread at which the longer-dated paper will pay interest.

The new debt is pari passu with the existing loan. But because it matures later and thus is structurally subordinated, it carries a higher rate, and in some cases more attractive terms. Because issuers with big debt loads are expected to tackle debt maturities over time, amid varying market conditions, in some cases, accounts insist on most-favored-nation protection. Under such protection, the spread of the loan would increase if the issuer in question prints a loan at a wider margin.

The second phase is the conversion, in which lenders can exchange existing loans for new loans. In the end, the issuer is left with two tranches: (1) the legacy paper at the initial spread and maturity, and (2) the new longer-dated facility at a wider spread.

The innovation here: amend-to-extend allows an issuer to term-out loans without actually refinancing into a new credit (which would require marking the entire loan to market, entailing higher spreads, a new OID, and stricter covenants).

Defaults and restructuring

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, e.g., 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.

When this occurs, the lenders can accelerate the loan and force the issuer into bankruptcy. That's the most extreme measure. In most cases, the issuer and lenders can agree on an amendment that waives the violation in exchange for a fee, spread increase, and/or tighter terms.

A payment default is a more serious matter. As the name implies, this type of default occurs 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 choose to either provide a forbearance agreement that gives the issuer some breathing room or take appropriate action, up to and including accelerating, or calling, the loan.

If the lenders accelerate, the company will generally declare bankruptcy and restructure its debt. This means that the borrower will avail itself of the formal court system. Alternately, borrowers and lenders can come to terms through a distressed exchange, and avoid the time and expense of bankruptcy court.

Distressed exchanges are a negotiated tender in which classholders will swap their existing paper for a new series of bonds that typically have a lower principal amount and, often, a lower yield. In exchange the bondholders might receive stepped-up treatment, going from subordinated to senior, say, or from unsecured to second-lien. This technique is used frequently in the bond market but rarely for first-lien loans.

S&P Global Ratings in many cases considers these programs a default and, in fact, the holders are agreeing to take a principal haircut in order to allow the company to remain solvent and improve their ultimate recovery prospects. However, this remains a judgement call as a borrower must be viewed as being distressed.

Another technique for addressing the issue of distressed debt is the sub-par loan buy-back. This technique grew out of the bear market that began in 2007. Performing paper fell to prices not seen before in the loan market—with many trading south of 70. This created an opportunity for issuers with the financial wherewithal and the covenant room to repurchase loans via a tender, or in the open market, at prices below par.

Sub-par buybacks have deep roots in the bond market. Loans didn’t suffer the price declines before 2007 to make such tenders attractive, however. In fact, most loan documents do not provide for a buyback. Instead, issuers typically need obtain lender approval via a 50.1% amendment.

Bankruptcy

Filing for bankruptcy means that the borrower is using the formal court system to restructure or dissolve its business. In the U.S., this means that they will file either Chapter 11 or Chapter 7. Chapter 11 allows for the company to restructure its debt and come back into business in an orderly fashion while being protected from its creditors. If the company is not worth saving, however, because its primary business has cratered, then the issuer and lenders may agree to a Chapter 7 liquidation, in which the assets of the business are sold and the proceeds dispensed to the creditors.

In other countries, bankruptcy processes are rarely as transparent and orderly as the U.S. system. The rest of this section will focus on the U.S. bankruptcy process.

Debtor-in-possession (DIP) loans are a critical part of the bankruptcy process. They are loans made to bankrupt entities. These loans constitute super-priority claims in the bankruptcy distribution scheme, and thus sit ahead of all pre-petition claims. Many DIPs are further secured by priming liens on the debtor’s collateral. Traditionally, pre-petition lenders provided DIP loans as a way to keep a company viable during the bankruptcy process, thereby protecting their claims. In the early 1990s a broad market for third-party DIP loans emerged. These non-prepetition lenders were attracted to the market by the relative safety of most DIPs based on their super-priority status and relatively wide margins. This was the case again in the early 2000s.

During that period, however, the landscape shifted because of more dire economic conditions. As a result, liquidity was in far shorter supply, constraining availability of traditional third-party DIPs. Likewise, with the severe economic conditions eating away at debtors’ collateral, not to mention reducing enterprise values, pre-petition lenders were more wary of relying solely on the super-priority status of DIPs, and were more likely to ask for priming liens to secure facilities.

The refusal of pre-petition lenders to consent to such priming, combined with the expense and uncertainty involved in a priming fight in bankruptcy court, greatly reduced third-party participation in the DIP market. With liquidity in short supply, new innovations in DIP lending cropped up, aimed at bringing nontraditional lenders into the market, including junior DIPs and roll-up DIPs.

Junior DIPs are facilities typically provided by bondholders or other unsecured debtors as part of a loan-to-own strategy. The providers receive much or all of the post-petition equity interest as an incentive to provide the DIP loans.

Roll-up DIPs combine pre-petition claims into the DIP facility. In some bankruptcies, DIP providers were given the opportunity to roll up pre-petition claims into junior DIPs that rank ahead of other pre-petition secured lenders. This sweetener was particularly compelling for lenders that had bought pre-petition paper at distressed prices and were able to realize a gain by rolling it into the junior DIPs.

Junior and roll-up DIPs are suited to challenging markets, during which liquidity is scarce. During more liquid times, issuers can usually secure less costly financing in the form of traditional DIPs from pre-petition lenders and/or third-party lenders.

Exit loans finance an issuer's emergence from bankruptcy. Typically, the loans are pre-negotiated and are part of the company's reorganization plan.

Regulatory issues

The leveraged loan market—like any capital market—is regulated by a group of financial authorities and is subject to regulatory changes that can affect companies, intermediaries, and investors. The majority of the regulatory changes currently impacting the market stem from the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into federal law in 2010. They include the following:

CLO risk retention, otherwise known as "skin-in-the-game." These regulations aim to ensure that CLO investors retain risk in the vehicles they structure. CLO managers, beginning on Dec. 24, 2016, under Section 941 of Dodd-Frank, as investment managers, are required to retain no less than 5% of the credit risk of assets they securitized, except for pools of qualified mortgages.

This retention requirement can be satisfied by either retaining a "horizontal interest," which is subordinated to all other interests—e.g., part of the equity tranche of a debt vehicle—or a "vertical interest," which would receive a portion of payments made into each class of debt issued by the securitization.

In Europe, regulators had proposed increasing this risk-retention requirement to be much higher—Paul Tang, the MEP who sponsored the bill in the European parliament, had originally proposed going as high as 20%. But in June 2017, the European Parliament reached an agreement with the Commission and Council to allow originators and sponsors of CLOs to maintain the mandatory risk-retention level at the current minimum of 5%. Keeping this "skin-in-the-game" level was a huge surprise, as many had expected an increase to at least 10%.

The institutions met for the seventh time to find an agreement, part of a wider securitization regulation to make asset-backed deals more "simple, transparent and standardized" (STS). The regulation, which is expected to come into effect in 2018, also forms part of the EU's 2015 plan to develop a fully functioning capital markets union by the end of 2019.

Leveraged lending guidelines in both the U.S. and Europe. In 2013, the Leveraged Lending Guidance (LLG) was put in place by the Federal Reserve Board (the FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (the OCC). These guidelines stated that loans that fail to meet credit standards will be deemed "criticized" or "special mention" by bank regulators. Banks that either underwrite or hold such loans could face penalties as a result.

In 2017, the European Central Bank came out with similar guidelines on leveraged lending for banks it supervises. These specified that the underwriting of transactions with a total debt to EBITDA ratio of more than 6x should only be done in exceptional and justifiable circumstances, and that credit institutions should ensure leveraged borrowers have the capacity to fully amortize their debt, or repay at least 50% of the total amount over a period of five to seven years.

Loan derivatives

Over the past fifteen years, loan derivatives have firmly taken hold in the market.

Loan credit default swaps (LCDS) are standard derivatives that have secured loans as reference instruments. In June 2006 the International Settlement and Dealers Association issued a standard trade confirmation for LCDS contracts.

Like all credit default swaps (CDS), an LCDS is basically an insurance contract. The seller is paid a spread in exchange for agreeing to buy a loan at par, or a pre-negotiated price, if that loan defaults. LCDS enables participants to synthetically buy a loan by short-selling the LCDS or sell the loan by buying the LCDS. Theoretically, then, a loanholder can hedge a position either directly (by buying LCDS 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 LCDS 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 the 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 two, 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 counterparty at 100, a 20-point pickup. Or instead of physical delivery, some buyers of protection may prefer a 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.

The Markit LCDX is an index of 100 LCDS obligations that participants can trade. The index provides a straightforward way for participants to take long or short positions on a broad basket of loans, as well as hedge their exposure to the market. IHS Markit administers the LCDX. Like LCDS, the LCDX index is an over-the-counter product.

Single-name total rate of return swaps (TRS) are the oldest way for participants to purchase loans synthetically. In essence, a TRS allows an institution to buy a loan on margin. Under a TRS program a participant buys from a counterparty, usually a dealer, the income stream created by a reference asset (in this case a syndicated loan). The participant puts down some percentage as collateral, say 10%, and borrows the rest from the dealer. Then the participant receives the spread of the loan less the financial cost. If the reference loan defaults, the participant is obligated to buy the facility at par, or cash settle the position, based on a mark-to-market price or an auction price.

Here's how the economics of a TRS work, in simple terms. A participant buys via TRS a $10 million position in a loan paying L+250. To affect the purchase, the participant puts $1 million in a collateral account and pays L+50 on the balance (meaning leverage of 9:1). Thus, the participant would receive L+250 on the amount in the collateral account of $1 million, plus 200 bps (L+250 minus the borrowing cost of L+50) on the remaining amount of $9 million.

The resulting income is L+250 * $1 million plus 200 bps * $9 million. Based on the participants' collateral amount—or equity contribution—of $1 million, the return is L+2,020. If LIBOR is 5%, the return is 25.5%. Of course, this is not a risk-free proposition. If the issuer defaults and the value of the loan goes to 70 cents on the dollar, the participant will lose $3 million. And if the loan does not default but is marked down for whatever reason—market spreads widen, it is downgraded, its financial condition deteriorates—the participant stands to lose the difference between par and the current market price when the TRS expires. Or, in an extreme case, the value declines below the value in the collateral account and the participant is hit with a margin call.

In addition to the type of single-name TRS described above, another way to invest in loans is via a TRS program, in which a dealer provides financing for a portfolio of loans, rather than a single reference asset. The products are similar in that an investor would establish a collateral account equal to some percent of the overall TRS program and borrow the balance from a dealer. The program typically requires managers to adhere to diversification guidelines as well as weighted average maturity maximums and weighted average rating minimums.

Like with a single-name TRS, an investor makes money by the carry between the cost of the line and the spread of the assets. As well, any price appreciation bolsters the returns. Of course, if loans lose value, the investor's losses would be magnified by the leverage of the vehicle. Also, if collateral value declines below a predetermined level, the investor could face a margin call, or in the worst-case scenario, the TRS could be unwound.

TRS programs were widely used prior to the 2008 credit crisis. Since then, they have figured far less prominently into the loan landscape as investors across the capital markets shy away from leveraged, mark-to-market product. In Europe, some investors use TRS in funds where physical investments in loans are prohibited by UCITS regulation.

Glossary

364-day facility
A revolving credit facility that has a term of a year or less.

Administrative agent
Bank that handles all interest and principal payments and monitors the loan.

Administrative agent fee
Annual fee typically paid to administer the loan (including to distribute interest payments to the syndication group).

Affirmative covenants
These covenants state what action the borrower must take to be in compliance with the loan. They are usually boilerplate and require a borrower to, for example, pay the bank interest and fees, provide audited financial statements, maintain insurance, pay taxes, and so forth.

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

Amend to extend
This technique allows an issuer to push out part of its loan maturities through an amendment rather than a full-out refinancing. These transactions have two phases. The first is an amendment in which at least 50.1% of the bank group approves the issuer's ability to roll some or all existing loans into longer-dated paper. The new paper is pari passu with the existing paper, but since it has a longer term, it carries a higher rate and sometimes more attractive terms. The second phase is the conversion, in which lenders can exchange existing loans for new loans.

Amendment fee
Compensation paid to lenders if the borrower asks for a change in terms, e.g., via an amendment after a loan closes.

Arranger fee
Fee earned by the arrangers for working on the deal. A new leveraged loan can carry an arranger fee of 1–5% of the total loan commitment, depending on the complexity of the transaction, market conditions, and whether the loan is underwritten.

Arrangers
Commercial or investment banks that have a hand in underwriting and syndicating a loan.

Asset based lending
Loans that 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.

Asset sales
One of the standard mandatory prepayments. Defined as net proceeds of asset sales, normally excluding receivables or inventories.

Assets under management (AUM)
The market value of all funds managed by a specific investment manager on behalf of investors.

Assignment sale
Type of secondary sale. The assignee becomes a direct signatory to the loan and receives interest and principal payments directly from the administrative agent.

Average break price
The average price at which loans or bonds are initially traded in the secondary market after they close and allocate.

Average new-issue clearing level
Simple average final all-in spread post flex, inclusive of current LIBOR or LIBOR floors, if any.

Average pro rata spread
The average spread of the revolver and term loan A tranches.

Average retail new-issue fee
The average fee paid by the arranger to lenders joining the syndicate, tiered so that larger commitments earn larger fees. Fees on the pro rata tranches generally differ from those paid on the institutional tranches.

Axe sheets
Lists from dealers with indicative secondary bids and offers for loans. Axes are simply price indications.

Base rates
Minimum rate that the loan will pay. LIBOR/Euribor are the most common base rates, but these can include Prime, CD, and an array of other formats.

Best-efforts deal
The arranger group commits to underwrite less than the entire amount of the loan, leaving the credit to the vicissitudes of the market. Traditionally, best-efforts syndications have been used for risky borrowers or for complex transactions.

Bids wanted in competition (BWIC)
A secondary auction of a portfolio of loans or bonds. Typically an account will offer up a portfolio of facilities via a dealer. The dealer will then put out a BWIC, asking potential buyers to submit for individual names or the entire portfolio. The dealer will then collate the bids and award each facility to the highest bidder.

Bifurcated collateral structures
Issuer divides a collateral pledge between asset-based loans and funded term loans. Asset-based loans are secured by current assets like accounts receivable and inventories, while term loans are secured by fixed assets like property, plants, and equipment. Current assets are considered to be a superior form of collateral because they are more easily converted to cash.

Big boy letters
These letters typically ask public-side institutions to acknowledge 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.

Bilateral credit line
Loan agreement with only one lender and where the debt is not syndicated to a group.

Book building
The process by which arrangers revise terms to benefit borrowers but also ensure that enough lenders are willing to participate in the transaction.

Borrowing base
The specific assets that secure asset-based loans. The size of the attached credit line is limited by a margin formula tied to the valuation of the underlying collateral.

Break price
The price at which loans or bonds are initially traded into the secondary market after they close and allocate.

Bridge loan
Loan that is intended to provide short-term financing to provide a bridge to an asset sale, bond offering, stock offering, divestiture, etc. Generally provided by arrangers as part of an overall financing package.

Build-out financing
Financing that supports a particular project, such as a utility plant, a land development deal, a casino, or an energy pipeline.

Business development company (BDC)
A U.S. public company whose sole business purpose is to invest in small and mid-sized companies.

Buyback
When an issuer or its private equity sponsor/owner buys back its senior debt below par in the secondary market in an attempt to reduce total debt.

Compounded annual growth rate (CAGR)
Annualized measure of an investment's growth rate over a multiyear time period.

Capital expenditures (CapEx)
Investments in physical assets, such as a plant, property, or equipment.

Cash flow loan
Form of asset-based lending. A loan that may be secured by collateral but is repaid by cash flow.

Cash flow metrics
Various analytics to evaluate and monitor the cash flow generated by a company. They include operating cash flow and free cash flow.

CCC downgrade rate
The number of issuers who have had their corporate credit ratings lowered to CCC over a given 12-month period divided by the number of corporate credit ratings at the beginning of that period.

Change of control
When an issuer's ownership structure is significantly altered. It can be triggered by a merger, an acquisition of the issuer, or a change in the majority of the Board of Directors.

Chapter 7
The U.S. Bankruptcy Code that governs the process for liquidating a company and its assets.

Chapter 11
The U.S. Bankruptcy Code that governs the process for restructuring a company and its assets.

Circled
When a loan or bond is fully subscribed at a given price it is said to be circled. After that, the loan or bond moves to allocation and funding.

Clearing yield
Yield at which an instrument first breaks into the market.

Collateralized loan obligation (CLO)
A structured security backed by a pool of loans. It uses leverage and is usually tiered with ratings ranging from AAA to equity.

CLO risk retention
Regulations for ensuring that CLO investors retain risk in the vehicles they are structuring, or "skin-in-the-game." CLO managers, beginning on Dec. 24, 2016, under Section 941 of Dodd–Frank, as investment managers, are required to retain no less than 5% of the credit risk of assets they securitized, except for pools of qualified mortgages. This retention requirement can be satisfied by either retaining a horizontal interest, which is subordinated to all other interests—e.g., part of the equity tranche of a debt vehicle—or a vertical interest, which would receive a portion of payments made into each class of debt issued by the securitization.

Club deal
A smaller loan (usually $25–100 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.

Co-agent/Managing agent
This title is used mostly as an award for large commitments and is generally meaningless with regards to loan administration responsibilities.

Commercial bank
Financial institution that provides services such as accepting deposits and issuing loans.

Commercial paper
Unsecured short-term corporate debt.

Commitment fee
Fee paid to lenders on undrawn amounts under a revolving credit or a term loan prior to draw-down.

Competitive auction
When putting together financing for a transaction, a sponsor usually solicits bids from arrangers before awarding a mandate.

Competitive bid option (CBO)
Allows the borrower 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.

Continuously offered closed-end funds
Investors can buy into these funds each day at the fund's net asset value (NAV). Redemptions, however, are made via monthly or quarterly tenders rather than each day.

Contributed equity
The sponsor's contribution to finance the LBO, calculated as the sponsor's equity divided by total transaction amount.

Cost of funds
A bank's own funding rate.

Coupon-clipping
A period when investors can expect income from yield without capital appreciation or loss.

Covenant amendment/waiver/relief
When an issuer has failed to maintain its financial covenants, it can appeal to lenders to relieve it of its requirements and waive the maintenance of those covenants for that time period. It can also, or alternatively, ask to amend the covenant levels to make them less rigorous.

Covenant-lite
Loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement.

Covenants
Various assurances by borrowers to do, or not do, certain things during the life of a credit.

Cover bid
The level at which a dealer agrees to essentially underwrite a BWIC or an auction. The dealer, to win the business, may give an account a cover bid, effectively putting a floor on the auction price.

Coverage covenant
Requirement that the borrower maintain a minimum level of cash flow or earnings relative to specified expenses, most

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

Coverage ratio

A measure of the company's ability to meet its financial obligations, for example interest coverage. The higher the ratios, the better the ability to meet these commitments.

Credit agreement

Document that contains the final terms and conditions of the loan.

Credit estimates/Private ratings

Assessments made by the ratings agency on the creditworthiness of the company that are not publicly disclosed.

Cross-border

A transaction that issues tranches in two markets, usually the U.S. and Europe.

Cross-guarantees

Formal assurances that the varied operating units associated with a borrower guarantee its assets as collateral.

Cure period

The amount of time that is granted to a borrower to cure any default.

Current assets

Balance sheet assets that are the most liquid—cash, cash equivalents, accounts receivable.

Current liabilities

Balance sheet liabilities that are most subject to payment on demand—short-term debt and accounts payable.

Current ratio coverage

Requirement 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).

Daily-access funds

Traditional open-end mutual fund products into which investors can buy or redeem shares each day at the fund's NAV.

Debt issuance

Generally, debt issuance refers to the volume of a high-yield or loan deal, or the collective volume of high-yield and loan deals over a set period of time. In a loan deal, one of the prepayments from the lender to the borrower is net proceeds from debt issuance. The typical percentage required is 100%.

Debtor in possession (DIP)

DIP loans are made to bankrupt entities in the U.S. These loans constitute super-priority claims on the bankruptcy distribution scheme, and thus sit ahead of all pre-petition claims. Many DIPs are further secured by priming liens on the debtor's collateral, or gaining a collateral lien that has priority over any pre-petition liens.

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 does not 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 preset period, say 30 days, during which an issuer can cure a default (the cure or grace period). After that, the lenders can take appropriate action, up to and including accelerating, or calling, the loan.

Default rate

Calculated by either number of loans or principal amount. The formula is similar. S&P Global defines a default for the purposes of calculating default rates as a loan that is any of the following: rated 'D' by S&P Global, made to an issuer that has filed for bankruptcy, in payment default on interest or principal, or restructured in such a way as to create a material loss to the lender.

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.

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.

Default risk

The likelihood of a borrower being unable to pay interest or principal on time.

Delayed-draw term loan

Lines of credit that may be drawn down for a given period—

The issuer pays a fee during the commitment period (a ticking fee) and the lines are then repaid over a specified period (the term-out period). These are primarily used to purchase specified assets or equipment, or to make acquisitions (acquisition or equipment lines).

Direct lenders
A form of corporate debt provision in which lenders other than banks make loans to companies without intermediaries such as an investment bank, a broker, or a private equity firm. The borrowers are usually smaller or mid-sized companies.

Disintermediation
The process where banks are replaced (or disintermediated) by institutional investors.

Distressed exchange
A negotiated tender in which classholders will swap their existing paper for a new series of bonds that typically have a lower principal amount and often a lower yield.

Distressed loans
Credits that are considered to be at a higher risk of defaulting. 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.

Distressed ratio
Share of the S&P/LSTA Loan Index that is trading below 80.

Dividend financing
When a company takes on debt and uses proceeds to pay a dividend to shareholders.

Documentation agent
Bank that handles the documents and chooses the law firm.

Earnings before interest, taxes, depreciation, and amortization (EBITDA)
Often used as a proxy for cash flow.

Equity bridge loan
A bridge loan provided by arrangers that is expected to be repaid by a secondary equity commitment to a leveraged buyout.

Equity cures
These provisions allow issuers to fix a covenant violation—exceeding the maximum leverage test for instance—by making an equity contribution.

Equity infusion
Typically seen in distressed situations. In some cases, the private equity owners agree to make an equity infusion in the company, or a new investor steps in to provide fresh capital to strengthen the company's balance sheet.

Equity issuance
The net proceeds of an issuer selling stock. Leveraged loans may require a borrower to prepay with proceeds of equity issuance. The typical percentage required is 25–50%.

European credit funds
Open-ended pools of debt investments that are not subject to ratings oversight or restrictions regarding industry or rating diversification. They are generally lightly levered (2 to 3 times) and allow managers significant freedom in picking and choosing investments.

Evergreen
The option for the borrower—with consent of the syndicate group—to extend the facility each year for an additional year.

Excess cash flow
Cash flow after all cash expenses, required dividends, debt repayments, capital expenditures, and changes in working capital. A borrower is sometimes required to prepay a leveraged loan with proceeds of excess cash flow.

Exchange-traded, closed-end funds (ETFs)
Funds that trade on a stock exchange. Typically, the funds are capitalized by an initial public offering. Thereafter, investors can buy and sell shares, but may not redeem them.

Executive summary
Part of the information memorandum or bank book. Provides a description of the issuer, an overview of the transaction and rationale, sources and uses of the debt being raised, and key statistics on the financials.

Exit financing/Exit loans
These are loans that finance an issuer's emergence from bankruptcy in the U.S. Typically, the loans are prenegotiated and are part of the company's reorganization plan.

Facility fee
Paid on a facility's entire committed amount, regardless of usage. It is often charged instead of the commitment fee on revolving credits, as these typically have competitive bid options that allow a borrow to solicit the best bid from its syndicate group.

Fair value
Evaluation of price at which an asset would transact in the secondary market.

Finance companies
Companies that borrow money to fund their loans. Finance companies tend to play in smaller deals. They exist almost exclusively in the U.S., where they consistently represent less than 10% of the leveraged loan market.

Financial covenants
Requirements of a borrower's minimum financial performance, e.g., that it must maintain a higher level of current assets than of current liabilities. There are two types of financial covenants, maintenance and incurrence.

First-lien debt (FLD)
Senior debt that holds the first priority on security.

First-lien debt to EBITDA (FLD/EBITDA)
Ratio of first-lien debt to EBITDA. One of the main ratios used in leverage analysis and financial covenants.

Fixed-and-floating lien
A lien that allows the borrower to dispose of assets without consent (thus the floating aspect). However, the proceeds must go through certain channels, including certain designated accounts, so that the borrower has the right to freeze those assets (fixing them) under certain circumstances.

Flex
Margin flex language allows the arranger to change spreads during syndication to adjust pricing. To entice investors to buy the credit, spreads are raised, or flexed up. When liquidity is high and demand outstrips supply, the spread is decreased, or reverse-flexed. A structural flex occurs when the arranger adjusts the size of tranches during syndication to reflect liquidity levels. In highly liquid times, an arranger may move debt from the more expensive tranches, such as mezzanine, to cheaper tranches, such as second-lien or first-lien.

Floating rate
A spread over a base rate, typically LIBOR, that is periodically reset. Borrowers usually can lock in a given rate for one month to one year.

Forward calendar
A list of loans or bonds that have been announced but not yet closed. These include instruments that have yet to come to market and those actively being sold but not yet circled.

Four-B loans
Loans rated BB+ to BB– by S&P Global and Ba1 to Ba3 by Moody's.

Free-and-clear tranche
A form of covenant-lite loan that allows issuers to tap the market for additional loans that are free of the restrictions of incurrence tests.

Full vote
When all lenders are required to approve material changes such as RATS (rate, amortization, term, and security) or collateral rights.

General corporate purposes
Use of a loan for working capital, general operations, and other business-as-usual purposes.

Go-anywhere fund
Global allocation funds are also called go-anywhere funds because they are very flexible with regards to the types of investments they can make. They can invest across all regions and asset classes, based upon the decisions of the management team.

Hard fee
A fee that may be applied to all repayments under a loan, including from asset sales and excess cash flow.

High-yield takeouts
High-yield bonds that are issued to refinance loans.

Highly leveraged loan
For before 1996, refers to loans with margins of L+250 and above, and from 1996 to present, refers to loans with margins of L+225 and above.

Hurdle rates
The minimum required rate of return.

Incurrence covenants
Requirement that if an issuer takes a certain action involving financing (paying a dividend, making an acquisition, issuing more debt), it would need to still be in compliance after that activity.

Industry overview
Part of the information memorandum or bank book. Provides a description of the company's industry and competitive position relative to its industry peers.

Information memo (IM)/Bank book
A description of the terms of the transaction. This typically includes an executive summary, investment considerations,

a list of terms and conditions, an industry overview, and a financial model. If the issuer is seeking capital from non-bank investors, the arranger will prepare a "public" version of the IM (bank book) stripped of all confidential information.

Institutional debt/Institutional facilities
Tranches that are sold primarily to institutional investors. They traditionally have a bullet repayment with little (1% per annum) or no amortization, a maturity of eight to nine years, and a spread of +250–325. They are frequently subject to a pricing grid and sometimes carry call premiums/prepayment fees.

Institutional investors
Loan and bond investors who are primarily funded by pooled funds. The funds can take the form of structured vehicles (CLOs), mutual funds, hedge funds, and pension funds.

Intercreditor agreement
Agreement as to the subordination and priority of repayment to all lenders, senior and subordinated, in the case of default. It applies to lenders across borders and codifies their positions in the absence of intervention from individual bankruptcy courts.

Interest
Payment to lenders for providing funding for a transaction, usually in the form of a spread over a base rate, and an array of fees.

Internal rate of return (IRR)
The percentage that represents the level at which the net present value of costs (negative cash flows) of the investment equals the net present value of the benefits (positive cash flows) of the instrument.

Investment bank
Financial institution that provides services such as raising capital by underwriting or acting as agents for clients. Unlike commercial banks, they do not take customer deposits.

Investment considerations
Part of an information memorandum or bank book. This section typically is utilized as management's sales pitch for the deal.

Investment grade
The credit segment where issuers are rated BBB– or higher.

IPO
An issuer lists—or, in the case of a P2P LBO, relists—on an exchange. A portion of the equity proceeds of the listing are typically used to repay some debt and the company can often issue new debt at more favorable terms.

Jumbo loan
Transaction that is greater than $1 billion.

Junior bondholders
The bondholders who are lowest in payment priority.

Junior DIPs
Facilities typically provided by bondholders or other unsecured debtors as part of a loan-to-own strategy.

Junior equityholders
The equityholders who are lowest in payment priority (behind preferred shareholders).

LBO
Buyouts of a company by a sponsor. Excludes recapitalizations, refinancings, and follow-on acquisitions.

LCD flow-name composite
A sampling of the loan market consisting of tranches that are widely traded in the secondary market, per LCD's discussion with dealers and investors in the market. A version is compiled for the U.S. market as well as the European market.

Lead arranger/bookrunner
A league table designation used to indicate the top dog in a syndication.

League table
A ranking of specific metrics for the loan market, for example lead arranger or sponsor.

Letter of credit (LOC)
Guarantees provided by the bank group to pay off debt or obligations if the borrower cannot.

Leverage covenant
A cap on the maximum level of debt, relative to either equity or cash flow, with the total-debt-to-EBITDA level being the most common.

Leveraged lending guidance (LLG)
Rules put in place by the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) in 2013. These guidelines state that loans that fail to meet credit standards will be deemed criticized or special mention by bank regulators. Banks that either underwrite or hold such loans could face penalties as a result.

Leveraged loan
A loan that (1) is rated BB+ or lower, **or** (2) is either not rated or rated BBB– or higher but (a) has a spread of LIBOR+125 or

higher and (b) 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.

LIBOR floor
An interest rate floor for a loan's base rate.

Liquidity
Measure of how easy it is to sell a loan in the secondary market. Something that is easy to transact is considered liquid. Something that is difficult to transact is considered illiquid.

Loan 100 Index
Short for the S&P/LSTA U.S. Leveraged Loan 100 Index, this Index is designed to reflect the performance of the largest facilities in the leveraged loan market.

Loan commitment
Agreed-upon funded size of a borrowing.

Loan credit default swaps (LCDS)
Standard derivatives that have secured loans as reference instruments.

Loan Syndications & Trade Association (LSTA)
The U.S. trade association representing the leveraged loan markets. The LSTA advances the interests of the asset class through research, documentation, education, and wide-ranging advocacy and support.

Loan-to-own
A strategy in which lenders—typically hedge funds or distressed investors—provide financing to distressed companies. As part of the deal, lenders receive either a potential ownership stake if the company defaults, or, in the case of a bankrupt company, an explicit equity stake.

LOC fee
Line-of-credit fee. The most common—a fee for standby or financial LOCs—guarantees that lenders will support various corporate activities.

Local currency options
In Europe, facilities can fund in a number of currencies other than the euro, particularly the British pound and the U.S. dollar.

London Interbank Offered Rate (LIBOR)
Standard base rate for calculating interest paid on bank loans. Rate at which banks can borrow from other banks.

Loss given default
Measures the severity of loss the lender is likely to incur in the event of default. Investors assess this risk based on the collateral (if any) backing the loan.

Maintenance covenants
These pledges are far more restrictive than incurrence covenants, because they require an issuer to meet certain financial tests every quarter, whether or not it takes an action.

Managed accounts
Separately managed investment accounts tailored to the particular requirements of the investor.

Mandated lead arranger (MLA)
This designation remains the most significant lender title for the bank(s) providing the primary arrangement and initial underwriting, and receiving the majority of fees. Only used in Europe.

Mandatory prepayments
Certain corporate activities and events trigger a prepayment requirement on leveraged loans. They include excess cash flow, asset sales, debt issuance, and equity issuance.

Mark-to-market
Mechanism by which loans are valued using available price data (bid/ask levels reported by dealer desks and compiled by mark-to-market services) rather than fair value (estimates based on whether the loan is likely to repay lenders in whole or in part).

Market technicals
The balance between market supply and market demand. If there are a lot of dollars chasing little product, then issuers will be able to command lower spreads. If, however, the opposite is true, spreads will need to increase for loans to clear the market.

Market-clearing level
The price or spread at which a deal clears the primary market.

Markit LCDX
An index of 100 LCDS obligations that participants can trade. The index provides a straightforward way for participants to take long or short positions on a broad basket of loans, as well as hedge their exposure to the market.

Maximum capital expenditures
Limitation on the borrower's ability to make capital expenditures (purchases of property, plants, and equipment).

Mergers & acquisitions (M&A)
Leveraged finance markets feature corporate mergers and acquisitions or M&A activity. This is where companies seek financing to buy or combine with other companies.

Mezzanine
A subordinated instrument that carries second-ranking security or, if the capital structure also includes second-lien, third-ranking security.

Mezzanine funds
Investment pools that traditionally have focused on the mezzanine market, providing subordinated debt for buyouts.

Middle market
An issuer with no more than $50 million of EBITDA.

Most-favored-nation (MFN) protections
Resets the yield of the existing loan to the rate of the new loan to make sure it remains on market.

Most-favored-nation (MFN) sunset
Time period (12 or 18 months) after which the MFN yield protection ends.

Multi-currency line
Allows the borrower to borrow in one or more alternative currencies (in most agreements this option is capped).

Negative covenants
These agreements limit the borrower's activities in some way. They are highly structured and customized to a borrower's specific condition, and can limit the type and amount of acquisitions and investments, new debt issuance, liens, asset sales, guarantees, etc.

Negative pledge
Issuers agree not to pledge any assets to new lenders to ensure that the interests of the loan holders are protected.

New-issue volume
The par amount of paper issued into the primary loan market for any stated time period.

Noncore acquisition
When a corporate issuer sells a division to a private equity firm.

Offers wanted in competition (OWIC)
A BWIC in reverse. Instead of seeking bids, a dealer is asked to buy a portfolio of paper and solicits potential sellers for the best offer.

Original issue discount (OID)
A way of remunerating primary lenders, usually institutional investors, by offering them a discount to par. Varies according to demand for the deal.

Par
Stated face or nominal value of the underlying instrument, usually expressed as a percentage.

Pari passu
Meaning equal footing. Describes situations where two or more assets are equally ranked by seniority without any display of preference.

Participation agreement sale
Form of secondary sale. The buyer takes a participating interest in the selling lender's commitment in the loan.

Payment in kind (PIK)
A type of debt whose interest payments come in the form of additional debt accrued onto existing debt.

Performance grids
Loan spread adjustments based on one or more financial criteria.

Performing loans
Loans that are not in default.

Platform acquisition
When a private equity group purchases a company in a unique business space in order to make subsequent acquisitions in the same business space. The first acquisition is the platform, with additional purchases to follow.

Portugal, Ireland, Italy, Greece, Spain (PIIGS)
Southern European countries of the eurozone and Ireland.

Prepayment fee
Fees paid by the issuer if the debt is repaid before maturity.

Price talk
The original target spread or spread range launched to the market.

Pricing grid (aka margin ratchet)
A set of financial measures that allows the issuer to pay lower

interest on the facilities. For example, if the issuer's debt to EBITDA is less than 3x, pricing is LIBOR+275; if such ratio decreases to 2.5x, pricing is LIBOR+250.

Primary assignment
Form of secondary sale, in which the agent holds the loan on its books for a short period after the loan closes, and then sells it to the investors. Primarily used by offshore accounts (principally CLOs and hedge funds) that are subject to certain tax consequences from buying loans in the primary.

Primary LBO
A company that is up for sale to private equity sponsors for the first time.

Prime rate
Refers to a bank's prime lending rate. The rate is reset daily, and borrowings 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.

Priming lien
During the bankruptcy process, DIP lenders may request additional collateral in the form of a priming lien—a lien that is senior or equal to any preexisting lienholder.

Printing a deal/inking a deal
Clearing a deal at a specific price and spread.

Private equity firm/Financial sponsor
Company that provides financial backing and makes investments in the private equity of companies.

Pro forma financials/Financial models
Detailed model of the issuer's historical, pro forma, and projected financials including management's high, low, and base case for the issuer.

Pro rata
Facilities sold to banks (revolving credit, TLA, acquisition facility, CapEx facility). These tranches generally have a gradual amortization until maturity (except for the revolver) and a maturity of six to seven years. They will usually carry a spread of +200 and greater and might have two to four step-downs based on a pricing grid.

Public to private (P2P)
A buyout of a publicly listed company by a private equity firm resulting in its delisting from the stock exchange.

Ratings-based grids
Adjustments in loan spread based on rating; typical in investment-grade loans.

RATS (Rate, Amortization, Term, Security)
Types of changes to an agreement that usually require a full vote of lenders.

Recapitalization
Changes in the composition of an entity's balance sheet mix between debt and equity either by (1) issuing debt to pay a dividend or repurchase stock, or (2) selling new equity, in some cases to repay debt.

Recovery
This is the opposite of loss given default—it is the amount a creditor recovers, rather than loses, in a given default.

Refinancing
The issuance of a new loan or bond to refinance existing debt.

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) 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.

Reorganization plan
Debtor's plan upon emerging from bankruptcy for returning to normal business and repaying pre-petition creditors.

Repayments
The total par outstanding amount of loans in the S&P/LSTA Leveraged Loan Index paid down in the specified time period.

Repricing
An amendment to the change in spread. In a market where spreads on new issues are declining, borrowers already in the market will ask lenders to allow them to reduce the existing spread on their loans.

Required lenders level
Usually just a simple majority used for approval of nonmaterial amendments and waivers or changes affecting one facility within a deal.

Rich/Cheap
This is terminology imported from the bond market to the loan market and refers to the investor's—and not the borrower's—perspective. 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, so it can be sold for a gain. 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.

Roll-up DIPs
Combined pre-petition claims in the DIP facility. In some bankruptcies, DIP providers were given the opportunity to roll up pre-petition claims into junior DIPs that rank ahead of other pre-petition secured lenders.

Rollover equity
Reinvesting funds contributed to the company under previous ownership into a new company under new ownership.

Running the books
Generally the loan arranger is said to be running the books, i.e., preparing documentation, and syndicating and administering the loan.

S&P European Leveraged Loan Index (ELLI)
A market value weighted index based on market weightings, spreads, and interest payments tracking the European loan market.

S&P/LSTA Leveraged Loan Index (LLI)
A market value weighted index based on market weightings, spreads, and interest payments tracking the U.S. loan market. The LLI is run in partnership between S&P Global and the Loan Syndications & Trading Association (LSTA), the U.S. loan market's trade group.

Secondary/Tertiary LBO
A secondary LBO (and tertiary LBO) is a sale from one sponsor to another sponsor.

Second-lien debt (SLD)
Loan that has second-priority interest on security. Subordinated to senior loans (TLA, TLB, TLC, etc.) but senior to mezzanine, high-yield, PIK notes, and equity. They are floating-rate-instrument-like senior loans, priced roughly 200–300 bps higher than senior loans. Second-liens are more expensive to prepay than senior debt since many second-liens have prepayment penalties in the first two years. Their maturity is usually one-half to one year longer than the TLC.

Second-lien debt/EBITDA (SLD/EBITDA)
Ratio of second-lien debt to EBITDA. A ratio commonly used in financial analysis and covenants.

Senior secured
Generally, the highest ranking instrument in priority of payment.

Seniority
Refers to where an instrument ranks in priority of payment. Based on this ranking, an issuer will direct payments with the senior-most creditors paid first and the most junior equityholders last.

Shadow default rate
The number of loans to issuers that, over a 12-month period, are (1) paying default interest, (2) in forbearance agreements (lender agreements to reduce or suspend payment requirements for a specified length of time), or (3) represented by restructuring advisors (specialists in reorganizing issuer balance sheets), divided by the number of loans at the beginning of that period.

Simple majority
The basic required lenders level used for approval of nonmaterial amendments and waivers or changes affecting one facility within a deal.

Single security agreement
Places second-lien lenders in the same creditor class as the first-lien lenders from the standpoint of a bankruptcy

Single-name total rate of return swaps (TRS)
A way for participants to purchase loans synthetically on margin. A participant buys from a counterparty, usually a dealer, the income stream created by a reference asset.

Soft call
Premium paid by issuer for early redemption.

Soft fee premium
This is paid by issuer for early redemption.

Speculative grade
Speculative grade is a rating of BB+ or lower on an issuer. It is also considered the leveraged range.

Sponsor to sponsor (S2S)
Deals where one private equity firm sells a portfolio property to another.

Spread/Margin
Amount over the base which the loan pays as interest. For example base+350 means that the spread is 350 bps.

Spread/Yield to call (STC/YTC)
The spread/yield to call is the primary spread adjusted for the break price over the stated call term, usually 3 or 4 years. The secondary spread/yield to call is the current spread adjusted for the current secondary market price over the stated call term.

Spread/Yield to maturity (STM/YTM)
The spread/yield to maturity is the primary spread adjusted for the break price over the stated term of the facility. The secondary spread/yield to maturity is the current spread adjusted for the current secondary market price over the remaining term of the loan.

Springing liens/Collateral release requirements
Language stating that the borrower must attach or release collateral if the issuer's ratings change. It is primarily attached to borrowers on the cusp of investment grade versus speculative grade.

Standstill agreement
In the case of two discrete security agreements, divided by a standstill agreement, the first- and second-lien lenders are likely to be divided into two creditor classes. Second-lien lenders do not have a voice in the first-lien creditor committees.

Staple financing
A financing agreement stapled onto an acquisition, typically by the M&A advisor. 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.

Stock repurchase
When a company uses debt proceeds to buy back stock.

Strategic acquisitions
Acquisitions undertaken by borrowers that are not related to private equity. The borrowers are usually corporations in the same or a related industry segment as the target company.

Structural flex
An arranger's adjustment of the size of tranches during syndication to reflect current liquidity levels. In highly liquid times, an arranger may move debt from the more expensive tranches, such as mezzanine, to cheaper tranches, such as second-lien or first-lien.

Structured finance
A complex financial instrument vehicle based upon an underlying pool of assets. For loans, the primary format is the Collateralized Loan Obligation (CLO), which securitizes a pool of loans and includes some amount of leverage.

Subpar loan buyback
Opportunity for issuers with the financial wherewithal and the covenant room to repurchase loans via a tender, or in the open market, at prices below par.

Subordinated bondholders
Debtholders who are ranked below the senior level.

Subsidiary guarantees
Assurances that the assets of subsidiaries are part of the asset pledge, so if an issuer goes into bankruptcy all of its units are on the hook to repay the loan.

Supermajority
Share of lenders, typically 67–80%, required for certain material requests such as changes in amortization in term loan repayments and release of collateral. It is a threshold higher than the simple majority level set for the approval of nonmaterial amendments.

Swingline
A small, overnight borrowing line, typically provided by the agent.

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

Syndication agent
Bank that handles the syndication of the loan.

Tangible net worth covenant
Requirement that the borrower maintain a minimum level of tangible net worth (net worth less intangible assets, such as goodwill, intellectual assets, excess value paid for acquired companies).

Term loan (TLA, TLB, TLC)
This facility 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 repay it based on either a scheduled series of repayments or a one-time lump-sum payment at maturity (bullet payment). The term loan A (TLA) is a pro rata facility, structured to meet the requirements of bank investors. The institutional term loans are the term loans B, C, and higher (TLB, TLC, etc.), and are structured to meet the needs of institutional investors.

Term out
This option allows the borrower to convert revolving borrowings into a term loan at a given date.

Terms & conditions (T&Cs)
Preliminary term sheet describing the pricing, structure, collateral, covenants, and other terms of the credit.

Total rate of return swaps (TRS)
A program under which a participant buys the income stream created by a loan from a counterparty on margin. The participant receives the spread of the loan less the financial cost plus base rate on its collateral account. If the reference loan defaults, the participant is obligated to buy it at par or cash settle the loss based on a mark-to-market price or an auction price.

Tranche
A layer of debt within a structured vehicle such as a CLO or a syndicated loan. The tranches within a single structure may have different risk and reward profiles. Also known as a facility.

Undertakings for Collective Investment in Transferable Securities (UCITS)
An investment vehicle created through EU regulations. These pooled funds are registered to Europe but can be sold to investors worldwide. They exist because regulations in the U.K. restrict the marketing of loans directly to retail investors.

Underwriter
Financial institution that commits the funds needed for the transaction and distributes (syndicates) the debt.

Underwritten deals
Transactions in which arrangers guarantee the entire commitment, then syndicate the loan. Some banks use this strategy to win mandates and earn lucrative fees.

Unitranche financings
Single-lender loans, often sliced up behind the scenes.

Unsecured
Loans that are not backed by collateral.

Upfront fee/new-issue fee
Fee paid by the arranger to lenders joining the syndicate, tiered so that larger commitments earn larger fees.

Usage fee
Fee paid when the utilization of a revolving credit is above a set level or more often below a certain minimum.

Voting rights
The percentage of lenders required to approve amendments or changes to a loan agreement. The levels may vary depending on the type of change (supermajority versus simple majority).

Watch list
Issuers on S&P Global Ratings' credit watch list.

Weighted average bid
A price at which an investor is willing to buy a loan, weighted by the par amount outstanding. By definition, larger deals will have a stronger influence on the average.

Weighted average institutional spread
Average spread of TLB and TLC tranches weighted by the size of each tranche.

Working capital
Current assets minus current liabilities.