

## Stepping back from the corporate debt cliff

### Potential strategies for the middle market



Approximately \$2 trillion in U.S. corporate debt is scheduled to come due between 2011 and 2015.<sup>1</sup> The high-yield credit market's resurgence is providing refinancing options for larger, higher-rated corporate entities; however, smaller issuers with more speculative ratings (or no ratings at all) continue to lack access to the high-yield market. These smaller issuers, typically referred to as middle-market companies (defined as those with EBITDA less than \$50 million),<sup>2</sup> may have trouble refinancing their debt in coming years because there are fewer options available.

In addition to being shut out of the high-yield market, banks have continued their conservative lending practices due in part to regulatory reforms, and many legacy collateralized loan obligations (CLOs) are nearing the end of their reinvestment periods in 2011 and 2012,<sup>3</sup> all of which compounds the difficulty middle-market borrowers face with looming debt maturities.

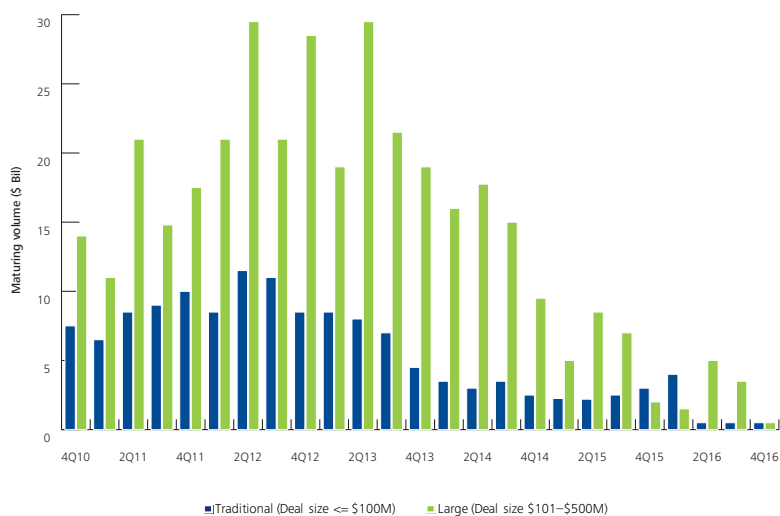
<sup>1</sup> "Credit Trends: U.S. Refinancing Study: Maturities Should Be Manageable Over Next Five Years, Except for 'B' Rated Issuers in 2013-2014," *RatingsDirect on the Global Credit Portal*, Standard & Poor's, October 27, 2010, [www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect)

<sup>2</sup> "Cash Flow Loans Still Not Abundant," *PE HUB Wire*, Lincoln International, October 19, 2010

<sup>3</sup> "Maturity cliff continues to erode, thanks to A-to-E and repayments," *Leveraged Commentary & Data*, Standard & Poor's Financial Services LLC (S&P), [www.lcdcomps.com/lcd/f](http://www.lcdcomps.com/lcd/f). Accessed November 22, 2010

Middle-market companies are standing at the edge of a debt maturity cliff. Record volumes of corporate debt were issued in 2006 and 2007, and \$450 billion in middle-market maturities are coming due between now and 2014 (Figure 1). This article examines the refinancing challenges facing the middle market and offers potential strategies to help these companies deal with maturing debt.

**Figure 1: Middle-market debt maturity coming due**



Source: Thomson Reuters LPC

**The looming loan maturity cliff**

Up to two-thirds (by number) of looming corporate maturities are comprised of lower-rated, middle-market borrowers, as many larger, higher-rated companies have already accessed a favorable high-yield market or executed “amend-to-extend” amendments to push out a significant amount of maturities. As a result of refinancing activities, near-term maturities have been reduced. Middle-market companies, however, have not been able to extend maturities at the same pace.

The landscape and timing of the maturities cliff appears to differ for corporate debt versus commercial mortgages. Many CLOs issued from 2005 to 2007 still have reinvestment windows and can continue to buy new loans; however, these reinvestment periods are coming to a close in two to three years. Corporate debt markets remain robust, allowing “good” companies (higher-rated, larger) to borrow, but blocking others (including middle-market companies); also, refinancing terms are more lender-friendly. Commercial mortgage activity is lower than at its 2007 peak for all types of borrowers in general, but liquidity is increasing with lenders coming back to the market. In fact, in February 2011, CMBS came back strongly with more than 6.5 billion in new securitization reported.<sup>4</sup> Those mortgages held in CMBS securities can only be extended for a short time (generally no more than one to two years), and changes in real estate values have resulted in an “equity gap” (loan balance greater than property value) on many loans.

**Industry reflections on the upcoming loan maturity cliff**

Attendees at Deloitte’s October 5 Dbriefs Webcast on distressed debt shared their thoughts and concerns about upcoming loan maturities. Of the 1,000 attendees responding to polling questions throughout the Webcast, nearly 40 percent identified themselves as borrowers. Among key findings:

- 51 percent of respondents had not heard about the upcoming loan maturity cliff and what year the issue will come to a head.
  - Among incidents or events that attendees think could have the greatest impact on credit markets in the next six to 12 months are a slow U.S. economic recovery (53 percent); a geopolitical event, including a terrorism act (12.6 percent); and a significant drop in the Yen, Euro and other currencies (12 percent).
- When asked what they view as the biggest impediment to resolving the loan backlog, attendees cite the sheer amount of distressed debt (46.5 percent); lack of access to credit markets (21.8 percent); and regulatory reform (10.4 percent).

<sup>4</sup> “CMBS Stages a Comeback,” The Alter Group, March 14, 2011

As used in this document, “Deloitte” means Deloitte LLP and its subsidiaries. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

- Respondents think that companies with annual revenue of \$1 billion or greater will have the greatest success in refinancing debt over the next 12 to 18 months (37.5 percent), followed by companies making \$500 million to less than \$1 billion (12.8 percent); however, nearly 15 percent say there would be no difference across revenue classes.
- Nearly 40 percent say that recent changes in the U.S. financial regulatory environment will have “somewhat of an impact” on the corporate debt cliff in the next five years; 34.5 percent say the changes will have a “significant impact.”
- Based on their current knowledge level, 46.1 percent of respondents report they would be comfortable working with a lender on a refinancing and/or workout; 27.5 percent say they would not be comfortable; and 26.4 percent say they didn’t know.

The lack of respondents who are aware of the loan maturity cliff issue, the backlog created by the current refinancing environment, and the number of respondents who are unsure about working with a lender on a refinancing may result in more respondents taking action closer to their maturity dates, which could put them at a disadvantage as many try to refinance at once.

### Some signs of loan market improvements

In general, commercial loan market conditions improved during 2010, which should be good news for all borrowers — including middle-market companies. Among the positive signs:

- **Commercial loan volume has increased.** 2010’s high-yield volume of over \$287 billion exceeded 2009’s high-yield issuance of \$166 billion by 72 percent.<sup>5</sup> 2010’s bank loan volume of \$233 billion exceeded 2009’s bank loan issuance of \$77 billion by 205 percent. (Note that bank loans still remain 56 percent below the historical peak of \$535 billion in 2007).<sup>6</sup>

<sup>5</sup> *High-Yield Weekly Review*, Standard & Poor’s Financial Services LLC (S&P), January 6, 2011

<sup>6</sup> Standard & Poor’s Loan Stats, Standard & Poor’s Financial Services LLC (S&P), Vol. 14, No. 1, January 2011

- **The maturity cliff continues to erode.** From October 1 through November 19, 2010, the amount of institutional loans with a maturity date of year-end 2014 contracted by \$33 million, to \$289 billion, primarily as a result of amend-and-extend and repayments. Total year-to-date 2010 reductions are \$163 billion.<sup>7</sup> Loan arrangers expect this activity to continue as long as market conditions remain supportive.<sup>8</sup>
- **Issuer earnings appear to have improved.** Due to modest growth and cost-cutting, Leverage Commentary and Data (“LCD”) reported that public filers posted a 12 percent year-over-year increase in EBITDA in the second quarter of 2010, the fourth straight quarter of EBITDA growth.
- **Defaults are lower.** Through December 2010, the trailing 12 months default rate by principal was about 1.8 percent, down from all-time, double-digit highs in late 2009.<sup>9</sup>
- **Liquidity appears to be improving.** During 2010, retail cash investors put \$16.3 billion into bank loan funds<sup>10</sup> and another \$13.0 billion into high-yield funds.<sup>11</sup>
- **More finance sources may be coming back online.** Middle-market finance companies and some new niche entrants appear to be becoming more active. CMBS issuances are still a fraction of what they were, but a pipeline appears to be starting to build. February 2011 CMBS activity was almost two thirds of all CMBS deals offered in 2010, and the rising volume in CMBS loan origination is a welcome indication that liquidity is returning.<sup>12</sup> Additionally, the issuance of CLOs remains down but structures appear to be getting simpler and more fund-like; there are fewer participants in the capital structure.

<sup>7</sup> “Maturity cliff continues to erode, thanks to A-to-E and repayments,” *Leveraged Commentary & Data*, Standard & Poor’s Financial Services LLC (S&P), [www.lcdcomps.com/lcd/f](http://www.lcdcomps.com/lcd/f). Accessed November 22, 2010

<sup>8</sup> Ibid

<sup>9</sup> LCD’s *Leveraged Lending Review-4Q10*, Standard & Poor’s Financial Services LLC (S&P), December 2010

<sup>10</sup> “Inflows to loan funds moderate, but close 2010 strong,” *Leveraged Commentary & Data*, Standard & Poor’s Financial Services LLC (S&P), December 31, 2010

<sup>11</sup> *Leveraged Commentary and Data*, Standard & Poor’s Financial Services LLC (S&P), December 31, 2010

<sup>12</sup> “CMBS Stages a Comeback,” The Alter Group, March 14, 2011

- **Banks are recovering.** Banks have been operating more conservatively for some time, since the financial crisis, and, for many banks, this has led to significantly higher capital levels. As a result, banks may be more favorably positioned to come to the aid of those middle-market companies facing maturities.
- **Sponsored middle-market transaction volume improved in Q4 2010.** Middle-market deals backed by private equity sponsors increased significantly in the fourth quarter of 2010 (Figure 2). Certain tax breaks available until year-end may have driven part of the increase, but the improvement is a positive sign for middle-market liquidity in the short term.

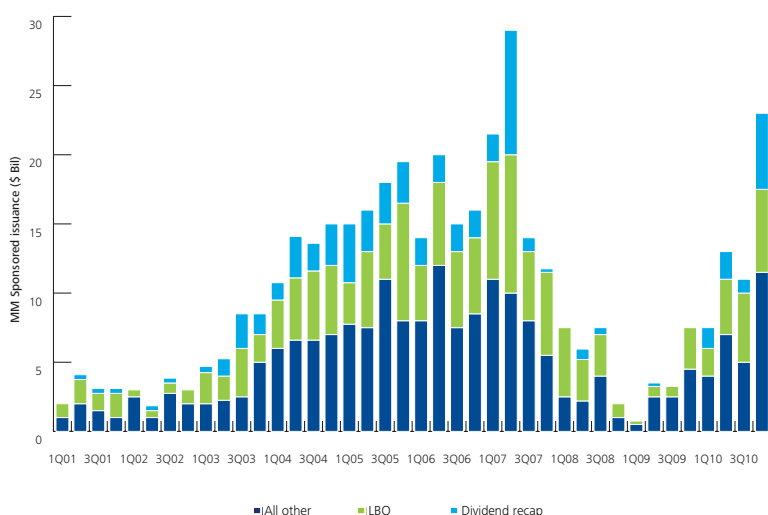
**Despite signs of improvement, middle-market borrowers still face challenges**

With market conditions apparently on the upswing, why is it so difficult for middle-market borrowers to obtain the financing they need to step back from the debt maturity cliff?

For one thing, scale plays into a creditor’s appetite to make a new loan or support a high-yield issuance. High-yield investors (e.g., mutual funds, bond funds) who have been driving most of 2010’s refinancing activity prefer larger, high-rated companies that are perceived to have greater credit quality and more operational stability. Once a possible issuance gets below a certain size (typically below \$150 million), it calls for a more “hands-on” type of capital source, such as a traditional commercial bank. However, banks are facing new risk-weighted asset issues and capital requirements emanating from financial reform legislation, such as Dodd-Frank and Basel III; also, many have tightened their underwriting standards such that credit may be more constrained. Banks are doing relatively little lending below investment grade; most lenders are chasing the best corporate clients. These factors may result in the middle-market niche being underserved by the banking community.

Concurrently, many CLOs are scheduled to stop re-investing proceeds in two to three years, effectively closing the window in which they can make new loans or agree to extend existing ones. Additionally, CLOs continue to focus partially on purchasing existing loans in the secondary market at a discount, versus participating in new loan issues in the primary market. Many believe that the trend of new CLO issuance is moving in a positive direction,<sup>13</sup> which would improve the liquidity landscape for all potential borrowers, including the middle market. However, there has not been material new issuance of CLOs and the future of new CLO issuance is still uncertain.

**Figure 2: Middle-market sponsored loan issuance explodes in 4Q10**



Source: Thomson Reuters LPC

<sup>13</sup> “CLO Mart Gets Off to Promising Start in 2011, but Challenges Remain,” *LCD News*, Standard & Poors Financial Services LLC (SGP) February 11, 2011

In the area of debt workouts, traditional C&I (commercial and industrial) loan borrowers with bank-only lender groups may find they have a bit more flexibility to negotiate amendments or extensions to existing deals. Aligning the interests of multiple lenders in a bank group can make the restructuring process more complicated. Borrowers with syndicated loans, for instance, may find a more difficult landscape. Syndicated loans can pose problems for middle-market borrowers because the various lenders in the group often have different concerns, varying balance sheet restraints, and interests that are not aligned. Reaching a consensus among these widely varied groups is often difficult. Specifically, for middle-market borrowers with loan facilities partially held by CLOs, traditional work-out strategies (such as a debt-for-equity exchange) that can be the best solution for a given situation are almost unacceptable for CLOs. This divergence of interests occurs because CLOs have constraints that emphasize receiving continued interest payments and maintaining the face amount of the debt, which sometimes comes at the expense of maximizing the ultimate recovery available to all stakeholders.

Finally, U.S. and global financial instability — in particular, the emerging sovereign debt and credit crisis and the possibility of inflation and rising interest rates — could negatively impact the U.S. high-yield market and deal a major blow to the lending system at all levels. As governments start to experience financial problems, their debt costs go up and, eventually, corporate debt costs could follow. A resulting investor flight to quality (e.g., to U.S. Treasuries versus corporate bonds) could create the potential for another dip in the world economy and a new wave of credit restrictions.

### Strategies that middle-market borrowers can use to face market challenges

Among potential strategies that may help middle-market borrowers position themselves favorably with potential lenders are:

- Start the refinancing process early, about 18 to 24 months before the debt’s maturity date.
- Identify and begin a dialogue with the middle-market finance companies and banks that are actively refinancing leveraged commercial loans.
- Explore “amend and extend” options with the borrower’s existing agent. CLOs are generally motivated to accept maturity extensions before their reinvestment periods end.
- Pay down debt — take advantage of opportunities to cut costs to reduce debt prior to refinancing.
- Consider a debt-for-equity swap. To the extent the amount of leverage is simply too burdensome for a company, relieving a company’s interest burden and improving cash flow by reducing debt can allow for the operating flexibility needed to generate growth and create value.
- Consider adding junior capital — if senior leverage is too high to refinance in today’s market, second-lien debt, mezzanine debt or minority equity may provide capital to partially repay senior loans.
- In some cases, the entire capital structure can be replaced by a unitranche loan, which is generally a single, senior, secured loan that can replace the entire debt structure and eliminate the need for multiple tranches with competing priorities with respect to collateral. Unitranche loans are typically priced on a blended basis, reflecting the same effective pricing that a traditional multi-tranche structure would provide.

### Distressed asset restructuring considerations

Potential issues for lenders and borrowers to consider when restructuring distressed assets include:

- Borrower level of cooperation/lender “fatigue”
- Borrower financial condition
- Legal options from existing agreements
- Current business plan — path to profitability
- Potential new equity sources
- Proposed exit strategies
- Additional funding requirements
- Recent collateral valuations
- Asset marketability
- Collateral condition (e.g., deferred maintenance issues)
- Existence of unpaid real estate taxes or other existing/pending liens
- Additional estimated costs to be incurred (e.g., foreclosure, holding, and/or transaction costs)

- Investigate nontraditional lending sources. Private equity funds and alternative asset managers with available capital are likely to become more active in the corporate debt refinancing market. Most of these firms are waiting for companies to get their balance sheets back in order and for the originating lenders to liquidate and equitize troubled loans. Also, finance companies could become players again because, unlike banks, they do not have to deal with capital and regulatory restrictions emanating from financial reform.

### Closing thoughts

Timing can be crucial when dealing with maturing debt. Middle-market borrowers should consider their pending maturities and the make-up of their existing lending group. Managers should consider investigating refinancing options as far in advance as possible — possibly as early as 24 months out. It is possible that lenders might experience a “rush to refinance” as the calendar approaches 2013 to 2015 and the looming maturity cliff. Also, syndicated loans that are held by diverse groups will likely take substantially more time to work out or refinance, adding importance to the need for early planning.

It is also important that a company seeking to refinance its debt knows its lenders well. Different lenders are dealing with middle-market borrowers with pending maturities in various ways, so organizations should consider researching an existing or potential lender’s history with lower-rated, highly levered or troubled borrowers and review their recent financing activity. Lenders, even when working with the same borrower, can act very differently from time to time, depending on their own situation. Some banks, for example, have a mandate to liquidate troubled loans and clean up their balance sheets as quickly as possible; others are willing to amend and extend. It depends on how much capital the particular bank has and its current appetite for risk. In any event, middle-market borrowers may be well served in the coming years if they are familiar with the middle-market lending environment, engage in active dialogue with various financing providers and industry professionals who can offer perspective, and monitor and evaluate financing options available in the middle market on an ongoing basis.

### Contacts:

#### Thomas Kaylor

Principal

Deloitte Financial Advisory Services LLP

+1 212 436 2409

tkaylor@deloitte.com

#### James M. Cassidy

Senior Vice President

Deloitte Corporate Finance LLC

+1 312 486 4928

jcassady@deloitte.com