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Q&A Investors Fear 'Extremely Aggressive' Terms on 'Clean' Loans: Guggenheim's Stein

Terms may reach "extremely aggressive" levels on loans not criticized by regulators as banks compete to underwrite them, according to **Tom Stein**, head of the capital markets group at **Guggenheim Partners** in New York. Guggenheim manages about $68 billion in leveraged and investment grade credit. Stein spoke to Bloomberg Brief's Kelly Blessing on Dec. 22.

Q: What stood out for you last year?

A: For 2014, leveraged loan volume will actually be down about 13 percent. While the overall decline was disappointing, the bright spot in the year was increased M&A activity, which represented close to 50 percent of total loan volume. The good news is that we've met and addressed a lot of the maturities that would otherwise be problematic for 2016 to 2018, as they've been pushed to 2019 to 2021.

Q: Why does that matter?

A: Default cycles tend to start anywhere from a year to two years after the beginning of interest rate increases.

Q: What about outside the U.S.?

A: Europe was actually a welcome bright spot in 2014 as volumes were up year-over-year. Despite the fact that Europe is a smaller portion of the global market, we could see increased cross-border financing activity with European issuers in 2015.

Q: What's the 2015 outlook?

A: I think M&A is going to steal the spotlight again. Second lien volume for all of 2014 is going to be roughly $36 billion and only $4 billion of that total figure came in the fourth quarter. So the toughest part of the market is going to be the opportunistic and second lien executions, the latter of which, relied heavily on the high-yield investor and some CLOs reaching for yield.

Q: Will those elements return?

A: CLOs issuance hit over $123 billion last year, so it significantly outweighed the $16 billion of loan mutual fund outflows. I would say we'll probably see $75 to $85 billion of CLO issuance in the U.S. in 2015, and I'm hopeful that the loan mutual fund outflows will stop, or at least begin to abate. Hopefully, any rise in rates will draw retail investors back into the asset class.

Q: What about total loan volume?

A: There are a number of factors impacting total loan market volume, which I think could be down 20 to 30 percent next year. The market will probably have less refinancing activity, lower repricing volume, and probably fewer recap financings. Moreover, one of the biggest themes that will continue to evolve, and shape the leveraged loan market for next year and beyond, is the impact that new regulation has on leveraged lending for the issuing banks.

Q: What is the regulatory impact?

A: I don't think that non-regulated banks are big enough to fully restore the volume that is being lost from larger banks exiting the loan market. Conversely, if a deal does not necessarily have the trappings of a criticized asset, I think the competitive nature around financings will be extreme. So all the banks will want to do the 5.5 times levered M&A deal that's clean and won't be a Shared National Credit exception. At the margin the banks would then be competing on terms and price. So, as an investor, I am fearful that the terms on those deals will be extremely aggressive on terms such as larger incremental facilities, looser collateral protections, wide RP allowances and other provisions that tend to concern us.

Q: Will loans beat high yield this year?

A: For 2014, the high-yield and loan market were very close in terms of total returns. However, returns for the two asset classes may diverge in 2015. For market-weighted investors, there's a greater chance that lower energy prices will have more of a negative impact in the high-yield market where energy issuers represent close to 14 percent of the index. Energy is a much smaller component of the total loan index, representing just 3 to 5 percent. I would also say that single-B and double-B loans and high-yield bonds are the best relative value in the market today, versus triple-C high yield and loans. We've been largely underweight the triple-C risk in loans and high yield for a good portion of 2014, and it actually benefited us in the fourth quarter.

Q: What about mid-market loans?

A: We tend to be very active in the upper middle market where deals sizes are between $350 and $500 million. We think that this segment of the market can represent some of the best relative value and is an area where we can be impactful, given our risk appetite. For example, when we anchor a middle market deal, we can sometimes influence the structure and terms of the financing.

Q: Better returns too?

A: The middle market premium can be as large as 100 basis points above the broadly syndicated market. But again, structure and terms are important to us. We tend to focus on characteristics like free and clear facilities, RP allowances, affirmative and negative covenants as well as financial covenants.

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AT A GLANCE

Where you grew up: Northern California

Where you live now: Riverside, Connecticut

Favorite music: Classic rock

Favorite movie: Gladiator

All-time favorite book: The Source by James Michener

Recent favorite book: Supreme Commander: MacArthur's Triumph in Japan by Seymour Morris

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