Private Debt Investor

By: Sergio Padilla
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NEWS & ANALYSIS

Cost of capital is still top of mind for lenders in the new year

Report by Davidson Kempner finds that although PIK and liability management exercises abound, the need for deleveraging may make itself apparent.

As temporary workout solutions such as liability management exercises and payment-in-kind interest abound, capital structures may soon be tasked with confronting their cost of capital, according to a report by Davidson Kempner Capital Management.

Distressed exchanges are at their highest level since 2008, a trend driven by corporate borrowers and sponsors embracing LMEs, which are aggressive strategies where companies raise capital through the transferring of assets to unrestricted subsidiaries or by issuing new debt to take priority over existing debt.

As of 30 September, distressed exchanges have exceeded $37 billion, directly in line with the great financial crisis, according to data the report sources from JPMorgan. Distressed exchanges occur primarily within corporate loans.

"The quoted default rates for bonds are so low, and yet as you dig into what's going on in loans there's actually a bit of distress," said Suzanne Gibbons, partner and head of research at Davidson Kempner. "It's because of the floating rate. Fixed rate bonds have the benefit of locked-in lower rates, whereas all the loan capital structures immediately got hit from higher rates. That's why so many of the defaults have been in the loan market."

Citing data from Moody's ratings, the Davidson Kempner report highlights the dispersion between defaults in high-yield bonds at 3.7 percent and Moody's loan default rate at 7.08 percent.

Direct lending features a default rate of 5 percent, according to data from Fitch Ratings. But as Private Debt Investor's latest cover story reports, measuring default rates on private mid-market loans can be difficult as ratings agencies examine different sets of loans, in addition to having unique definitions of what a default is and the methodology for determining one.

The Davidson Kempner report makes the case that the difference in defaults between public and private loans is the widespread use of payment-in-kind toggles for interest payments and liability management exercise-driven defaults in public loan markets.

It cites data from Goldman Sachs, which states that roughly 16 percent of business development company direct loans use PIK toggle coupons, and that because BDCs typically distribute 90 percent of their income to investors, this dynamic could prove problematic in the future.

With the subsequent growth of distressed exchanges and direct lenders, sponsors may no longer have to worry about angering creditors as there may be enough lenders to finance their next LBO regardless of aggressive LMEs.

"If you have a handful of lenders and you're a sponsor… you may try hard not to anger that handful of lenders, because there's nowhere else to go for financing, but if there's a very large number of lenders… the market will become naturally competitive," said Tony Yoseloff, managing partner and chief investment officer at Davidson Kempner.

But rather than an increase in liability management exercises in private debt, Yoseloff said it is more likely that there will be an expanded use of payment-in-kind toggles as well as lower rates of recovery. He added that in either scenario, it's likely neither strategy will be sufficient when a company or piece of collateral is struggling.

The report notes that recoveries in sponsor-led, first-lien loans have been on a downward trend since 2021, a record year for fundraising in private debt. Recoveries for those loans were north of 80 percent in 2010 and by 2024 were sliced nearly in half, to slightly more than 40 percent.

In addition, it cites Moody's data which shows that recoveries for first-lien loans with a prior LME are roughly 45 percent, while those with no prior LME are around 55 percent.

"Not only do you have a longer-term trend of recoveries going down, but you've got a secondary factor that companies that have gone through some sort of liability management exercise (or PIK) also do worse than companies that don't," said Yoseloff.

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