Leveraged Loans Set Record as Fed Sees Excesses: Credit Markets
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By Krista Giovacco and Sridhar Natarajan

March 1 (Bloomberg) -- The riskiest U.S. companies are tapping institutional investors for loans at the fastest pace ever, as some Federal Reserve governors warn of excesses developing in the market.

Borrowers obtained more than $88 billion in loans last month from non-bank lenders, exceeding the pre-crisis peak of $55 billion in April 2007 and more than tripling the $26.7 billion received in January, according to JPMorgan Chase & Co. More than 80 percent of the loans made this year were used to reduce borrowing costs or extend maturities.

While a growing economy is keeping defaults at almost half the historical average, the Fed's decision to maintain interest rates near zero for a fifth year has led at least two senior central bankers to express concern that excessive risk-taking may be happening in the loan market. The easy money in this market is fueling the $24 billion buyout of personal computer maker Dell Inc., the largest leveraged buyout since 2007.

"As long as the Fed continues to provide liquidity to the system and maintain low short-term rates, the bank market's going to continue to be robust," Reuben Daniels, managing partner of investment-banking firm EA Markets LLC in New York, said in a telephone interview. "I don't see the spigot turning off yet, but it has to end," said Daniels, a former co-head of U.S. investment banking at Barclays Plc.

Funding Buyouts

The boom in loan issuance will benefit buyout firms, said Carlyle Group LP's co-founder David Rubenstein. Carlyle obtained $3.2 billion of loans in January, including $2.3 billion provided by investors, to back its purchase of DuPont Co.'s auto-paint unit.

"Interest rates are so low it's hard to believe they can be sustained forever," Rubenstein, 63, said at the SuperReturn International conference in Berlin on Feb. 27. "There is no doubt that credit is readily available for private-equity deals. Banks are finding it very attractive to lend to people like us."

The average spread on institutional loans was at 377.6 basis points last month down from 515 at the end of June, according to Standard & Poor's Capital IQ Leveraged Commentary and Data. At the height of the market in March 2007 spreads were as tight as 243.3 basis points.

Default Swaps

Elsewhere in credit markets, the cost of protecting corporate debt from default in the U.S. fell, with the Markit CDX North American Investment Grade Index, which investors use to hedge against losses or to speculate on creditworthiness, decreasing 0.5 basis point to a mid-price of 87.5 basis points as of 11:50 a.m. in New York, according to prices compiled by Bloomberg.

The index typically falls as investor confidence improves and rises as it deteriorates. Credit-default swaps pay the buyer face r if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

The U.S. two-year interest-rate swap spread, a measure of debt market stress, fell 0.7 basis point to 14 basis points, as of 11:29 a.m. in New York. The gauge narrows when investors favor assets such as company debentures and widens when they seek the perceived safety of government securities.

Bonds of Redwood City, California-based Equinix Inc. are the most actively traded dollar-denominated corporate securities by dealers today, accounting for 6.7 percent of the volume of dealer trades of $1 million or more, at 11:52 a.m. in New York, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority.

The Internet infrastructure provider raised $1.5 billion yesterday in a two-part offering, according to data compiled by Bloomberg. Its $1 billion of 5.375 percent, 10-year notes sold at par rose to 100.31 cents on the dollar to yield 5.33 percent, Trace data show.

Dell Loan

Bank of America Corp., Barclays, Credit Suisse Group AG and Royal Bank of Canada are providing $13.8 billion in loans to finance Silver Lake Management LLC and Michael Dell's buyout of Dell, according to data compiled by Bloomberg.

Non-bank lenders such as collateralized debt obligations and hedge funds provided $119 billion of loans this year through Feb. 22, compared with $20 billion during the same period last year, according to JPMorgan. More than $96 billion of these transactions were refinancings backing interest-rate reductions.

Repricings

"Repricings have a lifespan," Marc Hanrahan, a New York- based partner and head of the global leveraged finance group at law firm Milbank, Tweed, Hadley & McCloy, said in a telephone interview. "When M&A activity heats up, the repricing trend will trail off because there will be new product and investors won't be forced to roll into cheaper paper."

Moody's forecasts the global speculative-grade default rate will be at 2.7 percent at the end of 2013, below the 4.8 percent historic average since 1983, according to the New York-based ratings firm.

"Compared to historical spreads we believe we're getting paid fairly well for the default risk we're taking in loans today," Steve Rixham, a managing director at Babson Capital Management LLC in Charlotte, North Carolina, which oversees $160 billion of assets, including $22 billion of leveraged loans, said in a telephone interview. "We think loans will remain attractive. Fundamentals for both high-yield bond and loan issuers remain in decent shape."

Investors added a record $5 billion into funds that purchase the floating-rate debt in February, according to Bank of America. Loan funds saw inflows of $1.3 billion this week, the Charlotte, North Carolina-based bank said in a report today.Investors added $4.4 billion to the funds in January.

"The barrel being full at loan funds and people being thirsty to use debt to finance transactions should produce a much better year this year than we've seen since the crash,"
Hanrahan said.

More Liquidity

The flood of new money has driven down the average difference in the bid and offer price on loans in the Markit iBoxx USD Liquid Leveraged Loan Index, which tracks 100 of the most liquid leveraged loans. The gap, also referred to as the bid-ask spread, has dropped to about 0.6 cent, from as much as 1.3 cents in October 2011.

"New CLO issuance and retail money coming in are trying to stay in the more liquid names and that is leading to the bid-ask spread narrowing," Scott Fries, a money manager at First Trust Advisors LP, which oversees about $900 million. "Most of this money is trying to stay invested in higher quality, higher flow names."

Year to date, there's been $14.96 billion of collateralized loan obligations sold, according to JPMorgan. The bank is predicting $65 billion of new CLOs this year. CLOs are a type of collateralized debt obligation that pool high-yield, high-risk loans and slice them into securities of varying risk and return.

Warning Signs

The Fed has kept rates low in an attempt to galvanize the economy, buying $85 billion in Treasury and mortgage debt a month and holding its benchmark rate in a range of zero to 0.25 percent since December 2008.

Esther George, president of the Federal Reserve Bank of Kansas City, voted against continuing the central bank's asset purchases at a January meeting out of concern about "the risks of future economic and financial imbalances," according to the minutes. Prices "of assets such as bonds, agricultural land, and high-yield and leveraged loans are at historically high levels," George said in a speech Jan. 10.

Fed Governor Jeremy Stein warned some credit markets, such as corporate debt, are showing signs of potentially excessive risk-taking, in a speech in St. Louis on Feb. 7. Stein cited leveraged loans and junk bonds as areas that have been "very robust of late."

"Issuers should come to the market and get the best terms they can get now," said EA Markets' Daniels. "When the liquidity flow stops you don't want to have missed one of the most accommodating bank markets in history."

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