



# Syndicated Loan Market

How financial needs are met and who supplies the capital has changed for large middle-market businesses.

by Michael T. Newsome

A steady tide of change within the commercial credit markets has quietly altered the manner in which the financing needs of large middle-market businesses are served and even who the principal capital suppliers are. It also portends changes in how distressed loans will be handled in the future. The catalyst for these changes has been the development of a very robust market for syndicated loans over the past fifteen years. Today, there are, in reality, two distinct markets. In the primary market, credit facilities are structured and underwritten between a borrower (commonly known as an issuer) and a group of lenders. Each lender undertakes a separate, severable obligation for a specific portion of the overall credit facility, which is governed by a common agreement and a single set of documentation. This isn't a new phenomenon; syndicated credit has been around for decades. The real innovation lies

in the development of an active and liquid secondary market, where a growing spectrum of investors traded in excess of \$170 billion of syndicated loans in 2005.

## THE PRIMARY MARKET

Large commercial and investment banks lead the primary syndication market, with the top players being JP Morgan Chase, BofA, Citigroup, CS First Boston, Deutsche Bank, Wachovia and Goldman Sachs. These institutions and a host of smaller ones originate loans, arrange the lending syndicates, and provide administrative services over the life of the syndication. Innovations such as improved market information on credit quality, pricing and deal structure, standardization of documentation, segmentation of risk into various loan tranches and "market flex" provisions that serve as a "mark-to-market" mechanism for pricing and structure when financings are originated have streamlined

syndicated corporate credit originations and stimulated market growth.

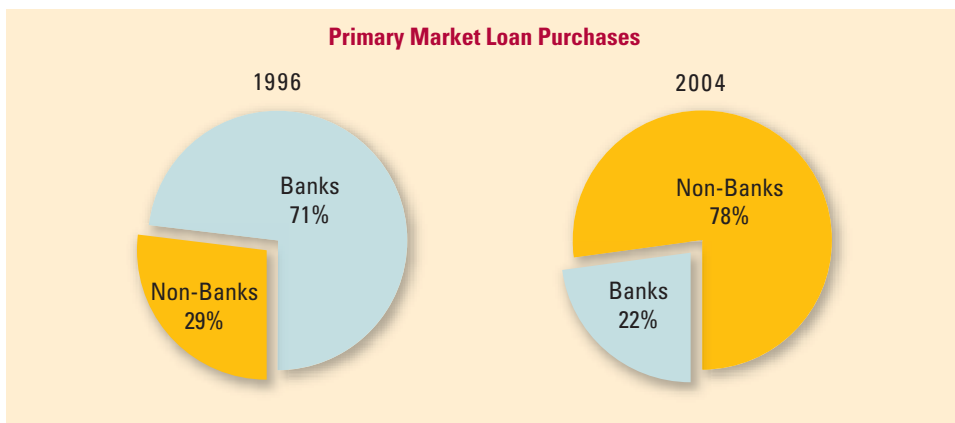
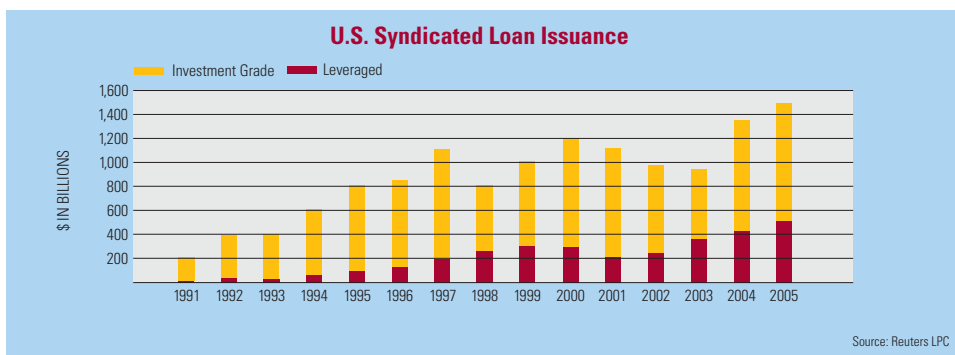
Improved information and standardization have allowed the syndicated loan market access to a much broader field of investors looking for attractive yield alternatives. The demand from non-bank investors for the paper fueled a massive increase in syndicated loan issuance. So much so, that commercial banks are no longer the predominant holders of syndicated senior debt. According to Standard & Poor's, banks now account for less than a quarter of primary-market loan purchases, as compared to about 70% in 1996. The dominant buyers of syndicated loans are now non-bank institutions, including hedge funds, loan-participation mutual funds known as prime funds, pension funds, traditional fixed-income investors, and Collateralized Loan Obligations (CLOs). These structured finance vehicles assemble pools of syndicated loans that are then securitized as bonds with several credit rated tranches (AAA, AA, BBB, mezzanine, and equity) with corresponding returns. CLOs represent more than 25% of the market.

## THE SECONDARY MARKET

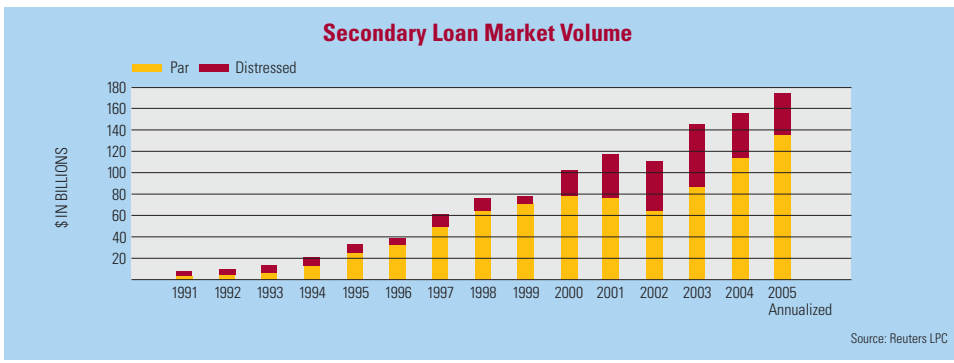
Secondary trading of syndicated loans began gathering steam in the 1990s. Initially, trading focused on distressed LBO<sup>1</sup> and LDC<sup>2</sup> debt originated during the 1980s. Regulatory guidelines for holding highly leveraged transactions and risk-weighted capital requirements brought about by the 1988 Basel Capital Accord created incentives for banks to move loans off of their balance sheets. In the early 1990s, major investment and money center banks set up trading desks that matched buyers and sellers. Today, more than 50 institutions have trading desks. Since 1991, secondary loan trading volume has grown at an annual rate of more than 25% to in excess of \$170 billion (market value basis) in 2005.

## WHERE ARE THE BANKS?

The upshot of the development of robust primary and secondary syndicated loan markets is the effective separation of loan origination and investment. The market now



<sup>1</sup> Leveraged buyout  
<sup>2</sup> Lesser developed country



exhibits many characteristics of the public bond and commercial paper markets where underwriters are completely different than investors. Traditionally, the principal corporate banking model has been “buy and hold”, where lenders provided a high level of relationship and monitoring for corporate borrowers. This included the patience, personnel and infrastructure to workout and rehabilitate troubled situations. The advent of risk-weighted capital requirements changed the analytical framework used by banks to evaluate portfolio performance and client profitability. It is pretty clear that commercial banks have concluded that the pricing available on most syndicated credits on a stand-alone basis does not provide an adequate return on the capital employed for these loans. Other investors provide cheaper capital. As a consequence, many banks have pared back their corporate lending infrastructure and pulled away from the syndicated market. The old model has been succeeded by an “originate and sell” approach, where effective credit originators (the big banks) can earn acceptable returns based on ancillary relationship revenue, syndication

fees, and a skim of the interest spread from other syndication investors.

Today, the predominant investors in the market are non-banks that have a significantly lower cost of capital and find the available yields attractive. These investors (hedge funds, prime rate funds and CLOs) act as portfolio managers that endeavor to earn a return by constructing portfolios within specific yield and risk parameters. They trade in and out of loans and use derivatives in an effort to achieve the target risk-adjusted return.

**TRADEOFFS**

A deep and liquid market for syndicated debt is a good thing, in most respects, for corporate borrowers. It allows more efficient access to abundant capital on accommodating terms and pricing that accurately reflects the market. That has certainly been the case in today’s roaring corporate debt market —covenant constraints have been relaxed, financial leverage has crept back up to peak levels, and credit spreads on leveraged deals are thin by historical standards. With an abundance of capital looking for yield, the situation could hardly be any friendlier for

capital users.

However, there are tradeoffs that corporate borrowers need to appreciate. As economic growth slows, interest rates rise, and a share of the investments made in the past few years inevitably sour, the inclination for many investors will be to sell their positions in the large and liquid secondary market. These participants in the market are not relationship lenders equipped with workout expertise or patience.

In the place of today’s CLOs and hedge funds, troubled firms can expect to find distressed debt investors buying a large share of their credit facilities. This happened in the last downturn and it promises to be a bigger phenomenon the next time around when these investors will strive to earn a return by acquiring distressed loans at a discount and then enforcing their rights and remedies to improve the value of those loans. There is an abundance of firms (many are hedge funds) with explicit strategies of accumulating a sufficient share of a company’s senior and/or second-lien debt to exert influence or control over how a business is restructured. In some cases, they will take direct control of the business by converting debt to equity. Troubled borrowers are likely to find that distressed debt investors will be less forgiving and flexible than relationship-oriented banks that were willing in the past to reset covenants and rehabilitate the customer. So, the tradeoff for better pricing and more liberal terms is that borrowers will be held to those terms. Shareholders and management can expect a rough ride should they falter with a highly leveraged balance sheet. ♦



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