

High Yield & Leveraged Loans

LME: Trading through prisoner's dilemmas

| FOCUS

Positioning around LME has become increasingly difficult given loose docs and co-ops. We analyzed 24 LMEs since 2017 ex-post and find that secured debt does not necessarily outperform junior debt, and bonds tend to outperform loans. We also find insufficient evidence to suggest that the nearest-dated maturity outperforms.

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Distressed exchanges have comprised over half of defaults since YE19. Weak covenant protections and increasingly onerous bankruptcies have permanently changed the default landscape. Liability management exercises (LMEs) are the primary means of circumventing bankruptcy, but have also led to "creditor-on-creditor violence", wherein the largest lenders are able to drive outcomes as a club.

Contentious LME has led to the rise of the co-op agreement. Co-ops are formed by ad hoc lender groups aiming to consolidate a majority position in one or more tranches of an issuer's capital structure such that they will be able to protect themselves in the event of an LME. While there is evidence that co-ops can be used both defensively and offensively by lender groups, their usage has increased in both complexity and frequency in recent years, creating a seismic shift in leveraged finance market structure.

Positioning portfolios around LMEs has become increasingly difficult. With LMEs that are able to strip material assets out of the reach of restricted groups, or create a new "superpriority" first lien in the claim on assets, market participants have been left to question whether their "lien" is providing them with adequate protection.

To help address this puzzle, we analyzed 24 LMEs since 2017. In doing so, we found that senior instruments in capital structures often underperformed more junior debt in the aftermath. We also found in roughly two-thirds of the LMEs from dual issuers, the best performing instrument in the capital structure post-LME was a bond, not a loan. Lastly, despite consensus suggesting that owning the nearest-dated maturity is the most effective form of defense against LME, given the negotiating leverage it provides to lenders, we find insufficient evidence to suggest that the nearest-dated maturity consistently outperforms post-LME.

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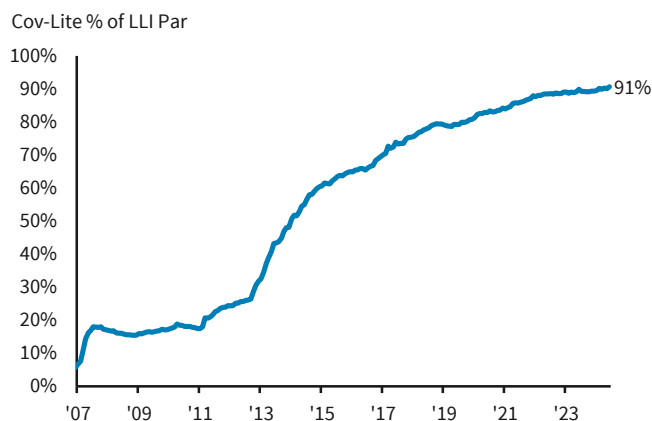
The default backdrop has evolved

As the credit cycle ages, balance sheets of highly leveraged issuers have become increasingly stressed. Nowhere is this more prevalent than in the leveraged loan market, where the tail of CCC issuers are facing meaningful fundamental headwinds ([Fundamentals stabilizing, but concerns in the tail](#) June 14, 2024). As of 1Q24 earnings, 47% of CCC issuers had <1x interest coverage excluding the effect of EBITDA add-backs per data from Bixby Analytics. This has led to a rise in defaults across leveraged finance, with default rates ending 1H24 at 3.1% for US HY and 6.1% for US loan issuers, up by 120bp and 390bp compared to YE22, respectively.¹

Meanwhile, the backdrop for liability management has become increasingly contentious, as lenders aim to enhance their claims on an issuer's assets via bespoke restructuring solutions, often at the expense of other lenders. The growth in this dynamic – now commonly referred to as "creditor-on-creditor violence" (or perhaps euphemistically "LME") – has been driven by a few factors, the first being a deterioration in covenant protection. Over 90% of the Morningstar LSTA Leveraged Loan Index is now "covenant-lite" (ie, lacking maintenance covenants), a metric that has increased sharply since the GFC ([Figure 1](#)).

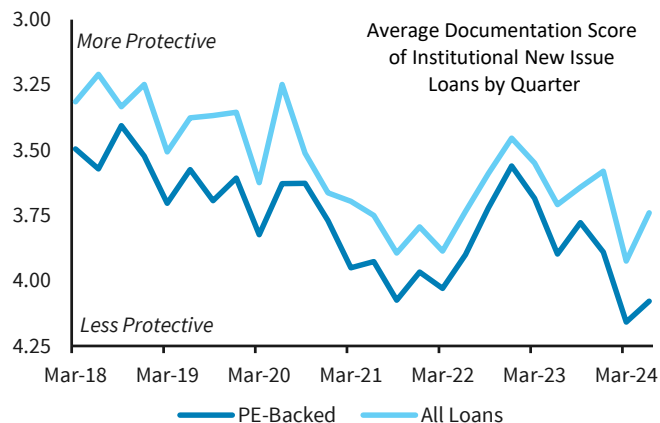
However, even more crucially than the increased presence of cov-lite is that covenant protection in general has become categorically weaker in leveraged finance, with indentures often granting an abundance of add-back permissions while containing numerous loopholes for LME exploitation. Compounding the trend was the golden age of deal flow that occurred post-COVID amid historically low funding costs, and the eagerness to deploy capital allowed for many of these protections to weaken significantly ([Figure 2](#)). This also occurred at a time when the CLO market began to flourish, providing a consistent and robust buyer base for leveraged loans, which now [own around two-thirds of the loan market](#).

FIGURE 1. The vast majority of the LLI is now covenant-lite



Source: PitchBook LCD, Barclays Research

FIGURE 2. The eagerness to deploy capital post-COVID allowed covenant protections to weaken meaningfully



Scores generated by Covenant Review on a scale of 1-5, with 5 being the least protective.

Source: Covenant Review, Barclays Research

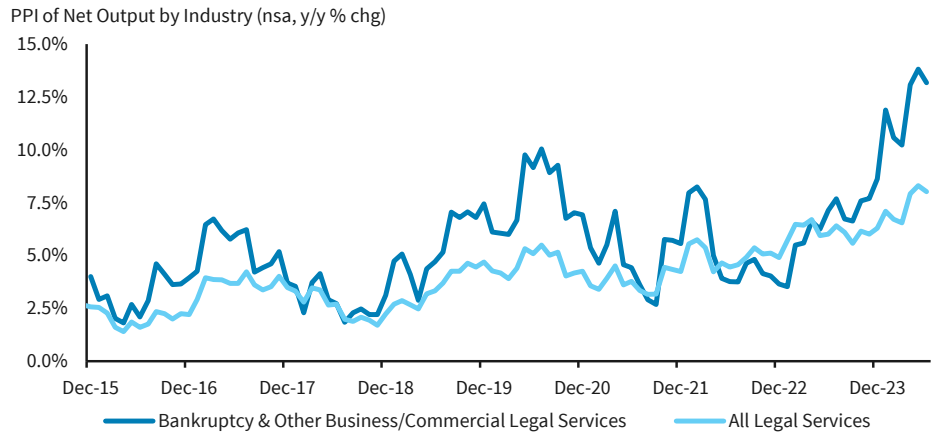
In addition, both issuers and lenders alike have become more reticent to file for bankruptcy given how burdensome the costs have become ([Figure 3](#)). For instance, *Bloomberg* reported earlier this month that in WeWork's recent bankruptcy, a law firm had asked the US Bankruptcy Court for over \$48mn in legal fees/expenses for representing the company from its initial filing

¹ Using LTM issuer-weighted default rates per Moody's (inclusive of distressed exchanges).

in 2023 to the approval of its restructuring plan in June.² Onerous costs and lengthy bankruptcy processes have given rise to a preferred alternative: distressed exchanges.

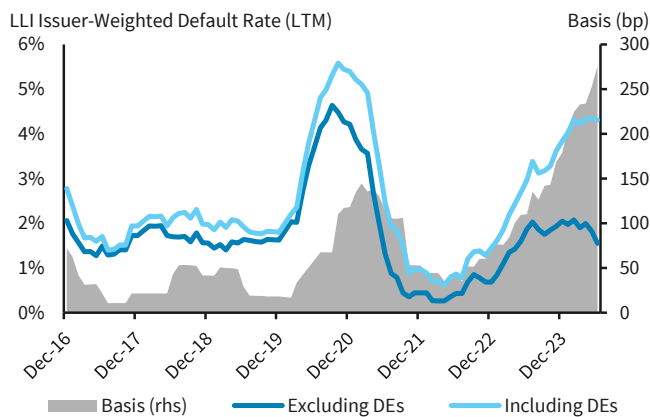
The gap between standard 'par' default rates and default rates that include distressed exchanges has widened materially in recent history. Including distressed exchanges in the issuer-weighted default rate on the Morningstar LSTA US LLI moves the LTM default rate nearly 300bp higher (Figure 4). This is because the proportion of defaults coming in the form of distressed exchanges has increased precipitously in the last several years, with over half of US defaults since YE19 being distressed exchanges (Figure 5).

FIGURE 3. Costs associated with bankruptcy have soared



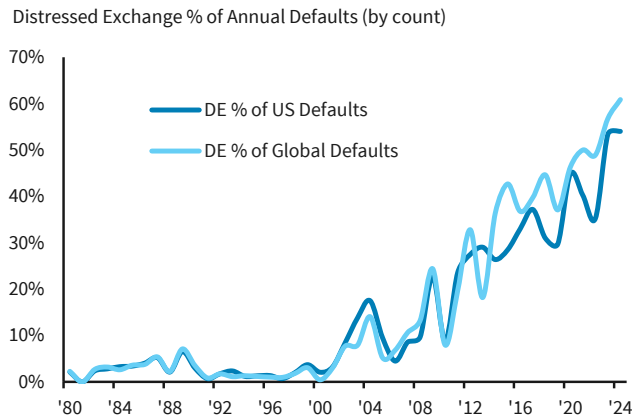
Net Output PPI is a price measure of an industry's output sold outside the industry.
Source: BLS, Haver Analytics, Barclays Research

FIGURE 4. Classifying distressed exchanges as defaults has become increasingly important for default rate calculations...



Source: PitchBook LCD, Barclays Research

FIGURE 5. ...since distressed exchanges have accounted for more than half of all US defaults since YE19



Across issuers of bonds and/or loans.
Source: Moody's, Barclays Research

Cooperation or coercion?

Documentation weakness alongside competition for claims on assets has allowed both issuers and lenders to devise more creative tactics to execute LMEs, using methods such as non-pro

² "Kirkland Seeks More Than \$48 Million for WeWork Bankruptcy Case", *Bloomberg*, July 8, 2024 ([link](#))

rata uptiers, dropdowns, and more recently, double dips (see [When I dip, you dip](#)). This evolution has been spurred by lenders becoming more willing to give up some form of their existing security to ultimately enhance their position in the capital stack. Historically, this would have been unheard of, as remaining at the top of the capital structure was widely considered the best possible approach to ensure maximal recovery. But as the LME tactics utilized by lender groups have evolved, so has the concept of "security."

If first lien debt can be uptiered by a new "superpriority" 1L instrument, or if the assets/IP that sits within a restricted group can be stripped and placed into a newly formed part of the capital structure, market participants have been left to question whether their "lien" is providing them with adequate protection. With over a third of HY index par now having some form of security, up from only 18% at YE19, this is particularly relevant for bond and loan investors. This development has led to a variety of changes within leveraged finance, with one of the most notable being the rise of the cooperation (co-op) agreement.

What are co-ops?

Co-op agreements are formed by ad hoc lender groups aiming to consolidate a majority position in one or more tranches of an issuer's capital structure such that they will be able to protect themselves from LME. They are not necessarily a new phenomenon (the earliest example of a co-op dates back to the early 2000s),³ but they have become more complex, tailored documents in recent quarters. Furthermore, they are also now being utilized more frequently and more proactively, with a recent *Reorg* article identifying at least 12 co-op agreements signed in 1H24 alone.⁴ This means that inter-lender group dynamics have become more important than ever.

The creation of a co-op agreement can be done proactively, by a lender group preparing for potential LME, or reactively, in response to an issuer that has already announced a coercive transaction. In some cases, law firms may drive the creation of co-ops themselves, corralling key lenders after seeing a borrower with weak covenant protections enter financial distress.

Pros & cons of co-ops

An idealist would say that co-ops allow for enhanced credit documents by "plugging holes" in weak covenants, thereby aligning lender protections more closely with the "spirit of the law" of credit investing. To a certain extent, this is true. The below excerpt from a recent article in the *Duke Law Journal* provides examples why:

*"These new provisions [enacted in co-op agreements] could alter simple majority voting schemes found in the original debt instruments and address other suboptimal provisions. For example, the original credit agreement may allow for modification of key rights by a majority vote of debtholders. A cooperation agreement signed by a supermajority of debtholders could impose a provision that restricts such a modification without unanimous consent of the group. This new agreement would ostensibly amend the original permissive term. Further, a cooperation agreement can restrict signatories from voting their debt in certain specific ways that could distort pro-rata distribution—a restriction that may not necessarily appear in a document with sponsor-favorable terms."*⁵

However, a cynic would say that co-ops are formed for aggressive purposes, in an effort to actively disadvantage minority lenders. While each co-op is formed for reasons unique to its situation, there is evidence of both defensive and offensive co-op usage in the media, as well as our conversations with market participants. That said, many recently-signed co-ops have seen

³ "Special Situations Insight: The subtle art of the cooperation agreement", *LevFin Insights*, March 10, 2023 ([link](#))

⁴ "Testing the Limits: Cooperation Agreements as a Shield Against Liability Management in 2024", *Reorg*, July 8, 2024 ([link](#))

⁵ "Creditors Strike Back: The Return of the Cooperation Agreement", *Duke Law Journal Online*, October 2023 ([link](#))

very high percentages of lender groups included, implying that co-ops may now be leaning more towards protecting the collective rather than punishing the minority.

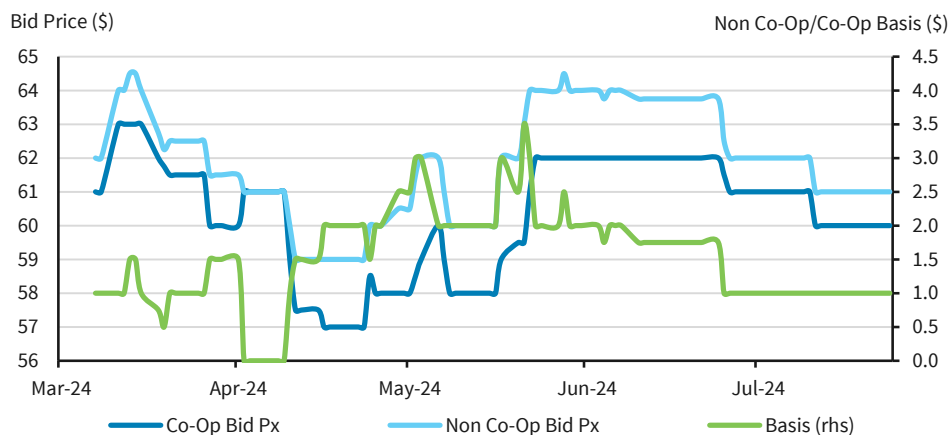
Furthermore, the efficacy of a co-op agreement may depend on the type of LME an issuer pursues. The *Duke Law Journal* article goes on to mention that a co-op agreement is inherently most effective against uptiering transaction since it is "premised on some sort of contractual subordination of a subset of the creditor group and various exit consents." In the case of a dropdown, for instance, co-ops may be somewhat less effective, given many of these transactions can occur without the need for lenders to provide requisite consents, as the company can seek third-party capital to lend against those assets. This suggests that uptiering LME transactions may decline as a proportion of total LMEs due to the increased usage of co-ops.

Co-op trading dynamics

When a co-op becomes effective, the bonds and loans that are subject to the co-op essentially become two distinct classes: co-op and non co-op. Once a bond or loan is bought by a member of the co-op, that paper trades as "co-op paper" until the dissolution of the co-op agreement. When a member of the co-op wants to buy more of a bond or loan that is subject to the co-op, they are typically able to buy either co-op or non co-op paper, although it depends entirely on the rules that the co-op members agree upon. However, the co-op paper cannot have its co-op "stamp" removed — it can only be traded among members of the co-op — so lenders that are not subject to the co-op are restricted to trading non co-op paper.

In secondary markets, there is differentiation between how co-op and non co-op classes trade for the same bond or loan. To display an example of this, Figure 6 shows the bid prices from the Barclays' trading desk for a bond where trading runs are published in co-op/non co-op format. The non co-op paper has been quoted at a premium to co-op paper by an average of \$1.5 since February. The co-op / non co-op price differential is highly idiosyncratic and is driven by supply/demand dynamics, the stipulations outlined in the co-op agreement, etc. For this reason, it is impossible for us to make a generalization of how co-op paper *should* trade versus non co-op paper. However, as some of the co-op groups increase in size, it is possible that the gap between co-op and non co-op paper diminishes.

FIGURE 6. Co-op and non co-op paper can trade at very different levels



Source: Barclays Research

When co-ops are formed, they can be narrow in nature or composed of lenders from many parts of the capital structure (ie, bonds and loans, 1L/2L/unsecured, etc). As such, at the time of a co-op's formation, both sizing and positioning tend to be critical factors. Investors with smaller-

sized positions in medium-to-large sized facilities are faced with increasingly difficult decisions regarding how to engage.

First, lenders must decide if the credit is one that they are willing to go "all-in" on. If they have conviction regarding the issuer's ability to turn around the business, they then must decide how large their position must be to earn a seat at the "co-op table." This has been somewhat mitigated in recent co-ops that have welcomed any and all lenders to join the coalition, but certain co-ops still remain exclusive clubs, open only to the largest creditors. Finally, the discussion must turn to determining the optimal position in the capital structure (ie, 1L vs 2L vs unsecured, bond vs loans, part of the curve, etc). While any distressed situation is idiosyncratic, we provide analysis to help investors strategize around this aspect more broadly in the section below.

Assessing performance post-LME announcement

Since the ability to navigate these situations has become highly complex, requiring heightened vigilance and nimbleness from credit investors, we analyzed a history of LMEs since 2017 to judge post-LME performance across the capital structure.

While it is difficult to produce an exhaustive database of LMEs, we use an aggregated list produced by Covenant Review as a starting point. Covenant Review groups LMEs into four broad categories: Dropdowns, Uptiering, Double Dips, and an "Other" catch-all that comprises LMEs that were unique in structure or used multiple elements of the preceding LME tactics (Figure 7). They capture over 50 unique LME events since 2014. If our goal is to determine trends across the capital structure, we next need to exclude events where the issuer only had one instrument outstanding at the time the LME was announced. After culling these situations and scrubbing for only events that had robust, clean pricing data, we are left with 24 LMEs to analyze since 2017 (through 1Q24). We mapped these LMEs to the days the transactions were announced in order to systematically analyze how performance fared in the aftermath of the LME.

FIGURE 7. High level descriptions of a selection of popular LME types

LME Type	Description
Uptiering	Uptiering (aka, "priming") typically involves an amendment executed via a consent of the majority of a lender group to allow for the incurrence of debt into a new priority tranche. Oftentimes, these are done in non-pro rata form, with only a portion of the lenders to the original facility becoming lenders in the new, senior priority tranche.
Dropdown	Dropdown transactions typically involve the transfer of one or more assets of a borrower to an unrestricted subsidiary (or from a guarantor to a non-guarantor restricted subsidiary), which is itself not subject to the covenants. The new entity then is able to incur new debt that is structurally senior to the existing debt.

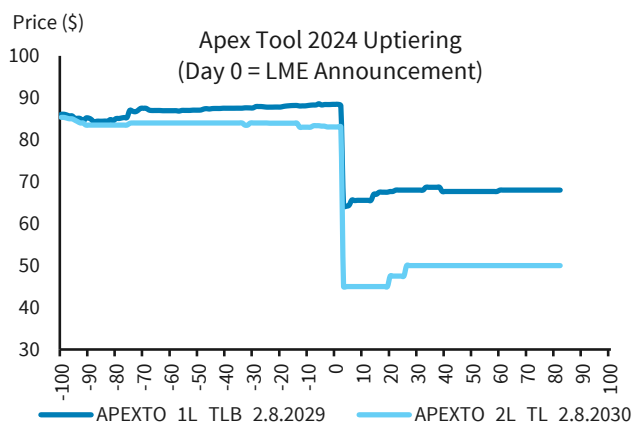
LME Type	Description
Double Dip	Double Dips typically involve the incurrence of debt of a newly formed (or preexisting) non-guarantor subsidiary, which is then guaranteed by one or more members of the restricted group ("the third party lenders"). This is followed by an intercompany loan from said subsidiary to the preexisting debt's issuing entity, which then becomes collateral for the newly issued secured debt, thereby giving third party lenders dual claim on the restricted group's assets.

We wrote an extensive note on Double Dips in October 2023 ([When I dip, you dip](#)).
 Source: Barclays Research

To do this, we assess the change in dollar price in percentage terms across all of the USD-denominated bonds and loans of each issuer in the 100 days following the LME announcement. If the instrument does not have a \$ price as of T+100 days from the LME announcement date, we use the last date that pricing data is available (by instrument) to determine which part of the capital structure out/underperformed. The latest prices we use are as of June 14, 2024.

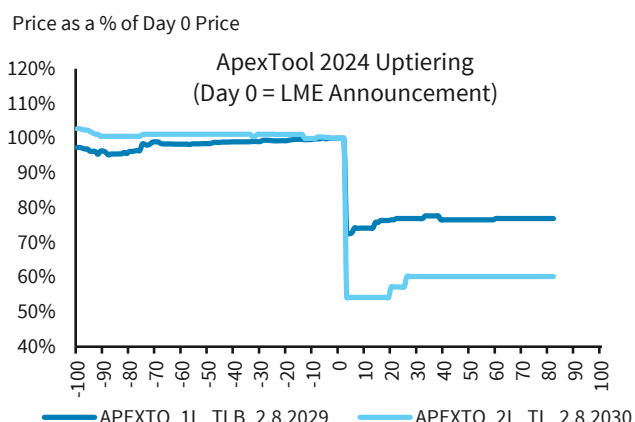
To display a simple example of how we approached the performance calculation, we provide an illustration in the two figures below. In February 2024, Apex Tool Group announced an uptier exchange of certain existing debt into multiple tranches of priming debt. After announcement (Day 0 in the charts below), the 1L loan fell from approximately \$88.5 to \$68 (-23%) while the 2L loan dropped from \$83 to \$50 (-40%). When comparing relative performance throughout our analysis, we use the percentage change in price post-LME ([Figure 9](#)).

FIGURE 8. Dollar price of outstanding Apex Tool loans at the time of LME announcement



Source: Bloomberg, LSEG LPC, Barclays Research

FIGURE 9. Change in dollar price of outstanding Apex Tool loans, rebased to the day the LME was announced (ie, Day 0)



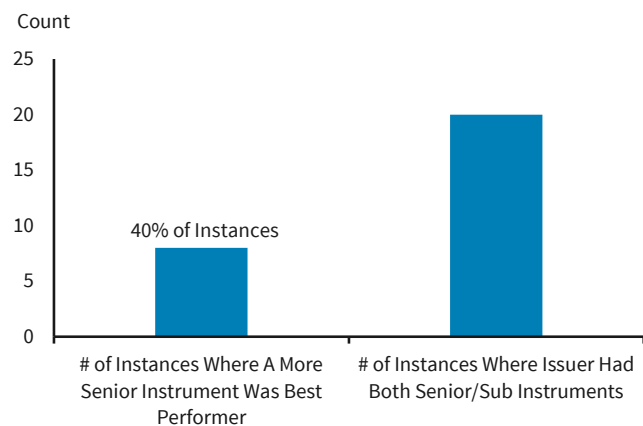
Source: Bloomberg, LSEG LPC, Barclays Research

While each LME is obviously bespoke in structure, and prices can reflect the potential for LME well in advance of its announcement in some situations, we believe the results are still useful in framing how various parts of the capital structure perform in the period following LME announcement. We analyze the situations through three primary lenses:

(1) Senior versus Subordinated: We don't mean this in the traditional legal sense of contractual subordination, but look at LMEs where an issuer had some difference in priority for the debt within its preexisting capital structure. Senior/sub combinations can take several forms (eg, 1L loan and 2L loan, 1L loan and unsecured bond, secured bond and unsecured bond, etc.). We count the instances when any senior instrument was the best performing part of the capital structure and find that this occurred in just 8 of 20 LMEs (40%) where an issuer had both a senior and junior instrument outstanding at the time the LME was announced. When looking by

LME type (Figure 11), we find that in two-thirds of all dropdowns, a senior instrument was the best performer. This is intuitive, given that the transfer of assets/IP outside of the reach of the restricted group tends to leave fewer assets for the already-subordinated junior instruments to have claims on. While it is difficult to speak in broad strokes about situations as bespoke as LMEs, the fact that less-senior instruments outperform senior a majority of the time speaks to the concern that investors should have on the efficacy of their existing liens.

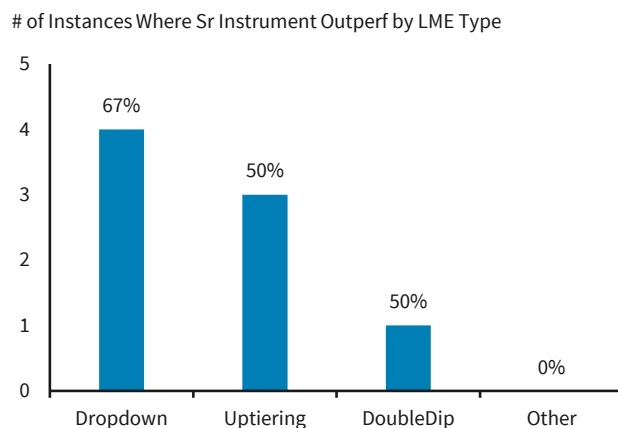
FIGURE 10. Instances where a higher-ranked instrument was the best performing part of the capital structure post-LME



Instances where a more junior instrument outperformed indicates that an instrument ranked Unsecured, 2nd Lien or Subordinated was the best performing instrument post-LME.

Source: Barclays Research

FIGURE 11. Instances where a senior instrument outperformed by LME type



Labels reflect the percentage of instances by LME type.

Source: Barclays Research

(2) Nearest-dated maturity: Figure 12 and Figure 13 display the proportion of LMEs that saw the most near-dated instrument outperform post-LME announcement. For this sample, we narrow the field to only include LMEs that had at least one maturity due within three years from the LME announcement date, since situations without a short-term maturity are not the ones where investors are making a strategic call on the front-end outperforming. In our sample of 13 LMEs that fit this criteria, the nearest-dated maturity was the best performer on only four occasions (31% of observations).

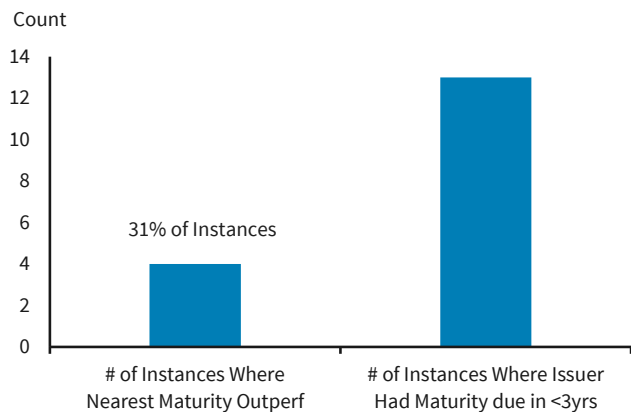
In our discussions with investors on how they prefer to position around potential LME, we frequently hear that creditors prefer being in the most near-dated maturity because an issuer will have to face you first temporally in LME negotiations. While our sample set is not overly robust, the situations that we analyzed did not provide sufficient evidence that this heuristic is true.

We also hear that lenders are even willing to sacrifice security to be in the nearest-dated maturity. Unfortunately, in each the four scenarios from our sample where the first-in-line maturity outperformed, the nearest-dated maturity was also ranked 1st lien, precluding us from being able to take a view on this dynamic. That said, each of these issuers did have junior debt at the time of LME announcement (unsecured or 2L). Not surprisingly, this signals that in situations where the nearest-dated maturity is also ranked 1st lien, it is likely the optimal position to take in the capital structure.

Also worth noting is that when we narrow the field even further to include only situations where the issuers had a maturity due within *one year* of the LME announcement date, the nearest-dated maturity outperformed three out of six times (50%). In the situations that fit this criteria but did *not* have the nearest-dated maturity outperform, that maturity was already trading

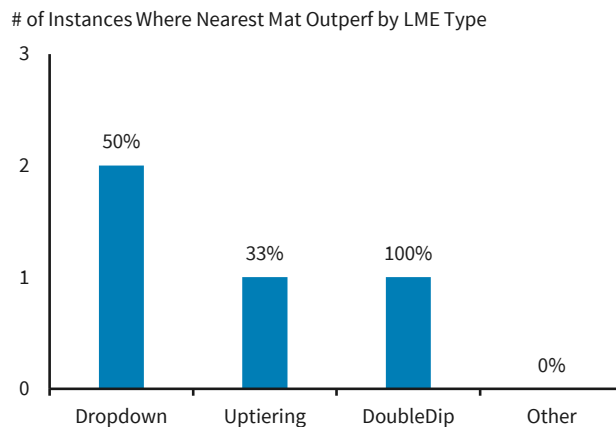
close to par, creating limited room for upside, or the LME was specifically targeting another instrument in the capital structure. This is informative in that it implies that as the clock runs down, the nearest-dated maturity is capable of outperforming, so long as it can be bought at a fair/discouted price.

FIGURE 12. Instances where the nearest-dated maturity outperformed post-LME



Source: Barclays Research

FIGURE 13. Instances where the nearest-dated maturity outperformed by LME type

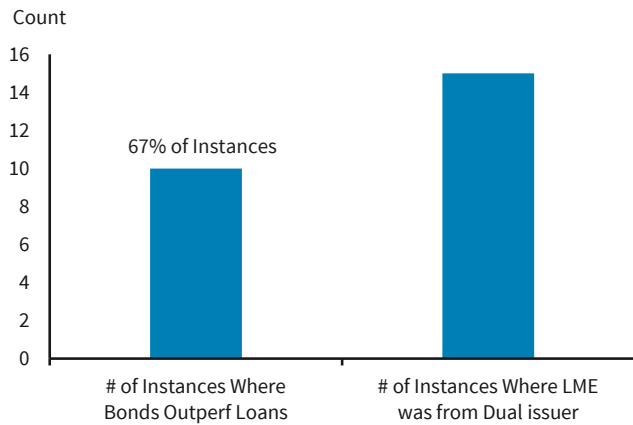


Labels reflect the percentage of instances by LME type.
Source: Barclays Research

(3) Bonds versus Loans: Lastly, we looked at the frequency of bonds outperforming loans post-LME. As seen in Figure 14, in a strong majority of LMEs (10 out of 15, or 67%) from dual issuers, one of an issuer's bonds was the best performing instrument post-LME announcement. It is difficult to derive any trends by LME type in this portion of the analysis, given 6 of the 10 instances of outperformance are classified as "Other" by Covenant Review's definition. However, one notable trend is that in 8 of the 10 instances, the bond that outperformed was an unsecured bond. This is likely a testament to the fact that leading into the LME, bonds with less security are typically punished more, and that once a liquidity solution is found, they are able to rally more than the 1L/secured part of the capital structure, as the outcome is typically better than a traditional bankruptcy.

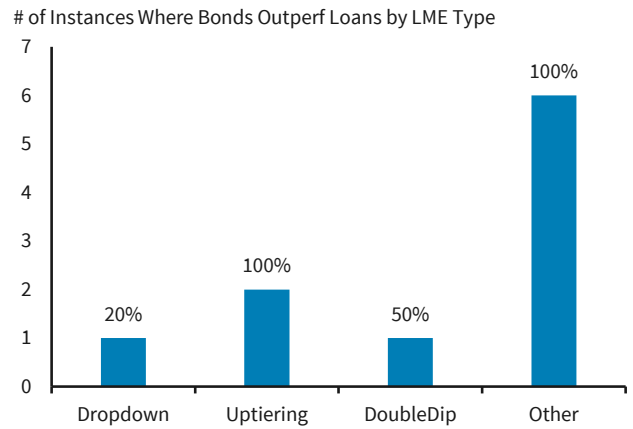
Historically, the loan market may also have been somewhat structurally disadvantaged in the case of LMEs relative to the bond market. While the ability to participate in distressed exchanges differs across CLO documentation, many CLOs have struggled to either take equity or put in more capital, hurting their ability to engage in some forms of distressed LME. We believe newer CLO documentation has improved these capabilities significantly. In addition, the willingness and ability of banks to help CLOs face issuers through "fronting" or "seasoning" transactions has also reduced barriers to engagement in LME for the CLO market.

FIGURE 14. Instances where bonds outperformed loans post-LME



Using dual issuers only.
Source: Barclays Research

FIGURE 15. Instances where bonds outperformed loans by LME type



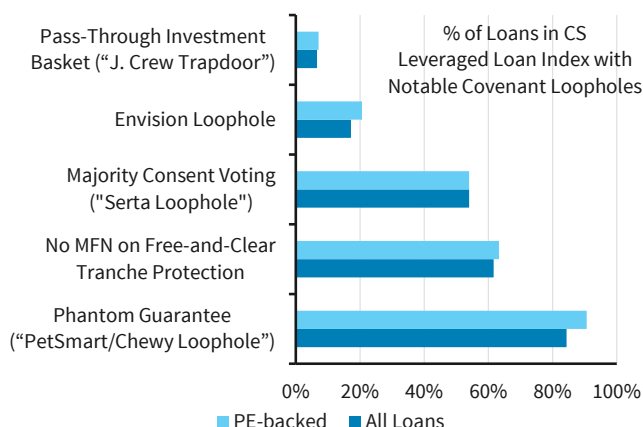
Labels reflect the percentage of instances by LME type.
Source: Barclays Research

Why we expect creditor-on-creditor violence to persist

Our interactions with clients regarding trends in LME often lead to the same question: "what inning are we in?" While it is impossible to answer this question with any degree of precision, we are of the view that LME will only become more contentious from here for a variety of reasons.

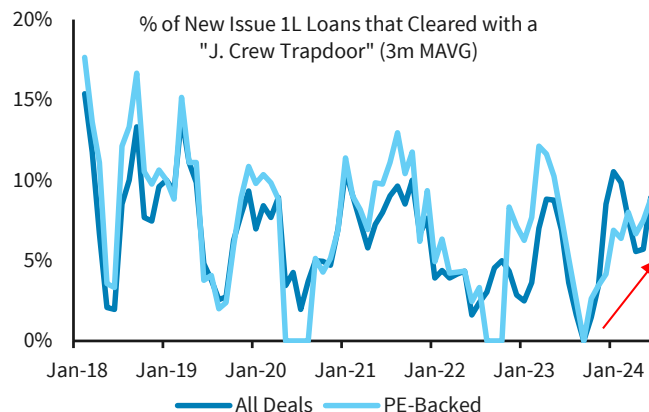
The first is that documentation standards are likely to remain loose for the foreseeable future. There are an abundance of outstanding loans that still contain many of the documentation loopholes that have been exploited in well-publicized LMEs from recent years (Figure 16). While one may look at Figure 16 and believe that it is simply a function of loans that still need to be termed out, that is not the case. Figure 17 shows that the "J. Crew Trapdoor" – a mechanism through which J. Crew was able to "dropdown" its IP assets into an unrestricted subsidiary such that it created additional investment capacity before executing a series of coercive exchange offers to delever its balance sheet – is still prevalent in many *new issue* loans. So this is not a matter of old vintages being termed out – instead, it is a function of the market's complacency and need to deploy capital despite weakness in covenant protection.

FIGURE 16. Many outstanding loans have the same documentation loopholes that were exploited in notable prior LMEs...



Source: Covenant Review, Barclays Research

FIGURE 17. ...and some are still be included in new issues today



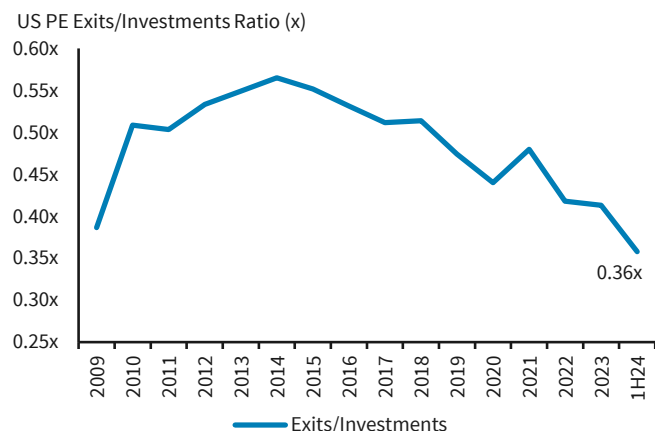
Source: Covenant Review, Barclays Research

Second, while co-ops are fairly novel phenomenon, they have become an integral part of investing in leveraged finance. We expect co-op agreements to become even more commonplace and even more complex, but despite this evolution in the marketplace, co-op agreements will likely never be a perfect fix for mitigating lender-on-lender violence. For instance, the formation of multiple co-ops with competing interests can complicate matters further, and it is theoretically possible for co-ops to be formed *within* some preexisting co-ops, effectively rendering the former one useless. While inter-lender relationships remain fragile and burned bridges may never be fully repaired, it is necessary to consider the extremes of potential outcomes in navigating an increasingly combative marketplace.

Perhaps the best cause for hope of moderation in aggression is that some recent co-ops have included holders across multiple classes of debt. If the majority of each portion of the capital structure is signed up to a co-op, the potential for creditor-on-creditor violence is greatly diminished. An issuer may still have ways around this (for example, a private credit loan as part of a dropdown), but it increases the chance of a negotiated solution that maintains the normal waterfall or a bankruptcy filing that, in theory, does the same.

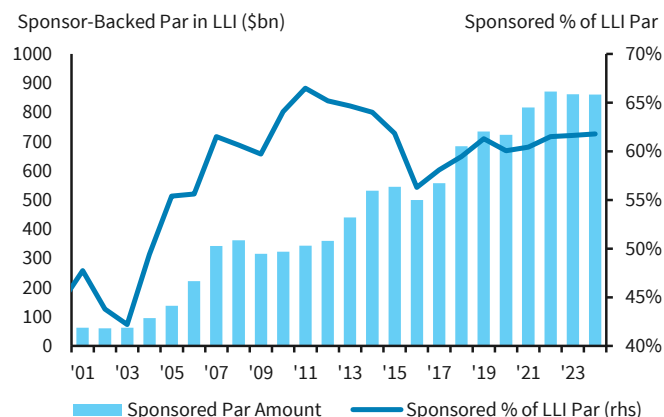
An additional factor at play that is supportive of more LMEs is the current state of the private equity industry. With rates several points higher than the ZIRP era of 2020-21, many sponsor-backed deals are still absorbing valuation resets, which can be helped by deleveraging through capturing the discount in existing securities. This is compounded by buyer-seller valuation gaps that have created a backlog of exits, leading to the lowest exits/investments ratio for US PE since at least 2009 (Figure 18). This means that sponsors have had to get more creative with manufacturing returns, which can be seen in the use of proceeds of recent primary market activity. Amid the technical strength of the BSL market YTD, dividend/recaps have increased as a proportion of overall supply in 2024 (see [Strength begets supply](#)). This, in turn, also compounds documentation weakness, as sponsor covenant protections tend to be weaker (see Figure 2). One example of this can be seen in the percent of new PE-backed BSL loans containing portability (Figure 20).

FIGURE 18. A lack of exits from private equity has pushed the exits/investments ratio to its lowest on record in 1H24



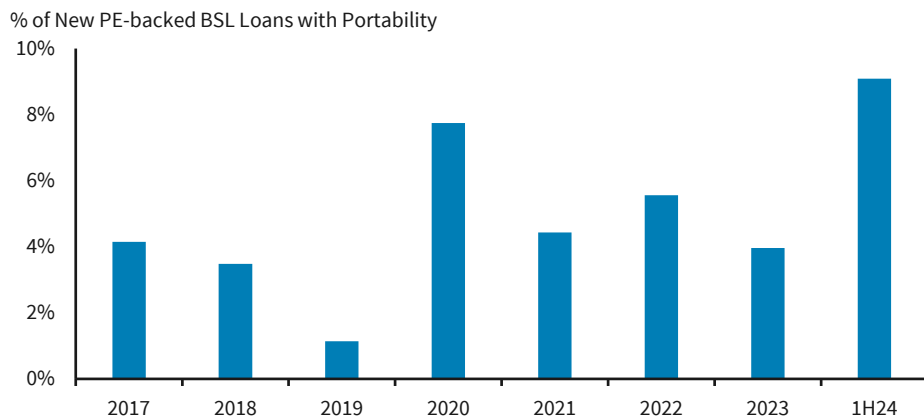
Source: PitchBook, Barclays Research

FIGURE 19. Sponsors remain a dominant force within the BSL market



Source: PitchBook LCD, Barclays Research

FIGURE 20. Portability features have been integrated into deal documents at a record pace in 2024



Source: Covenant Review, Barclays Research

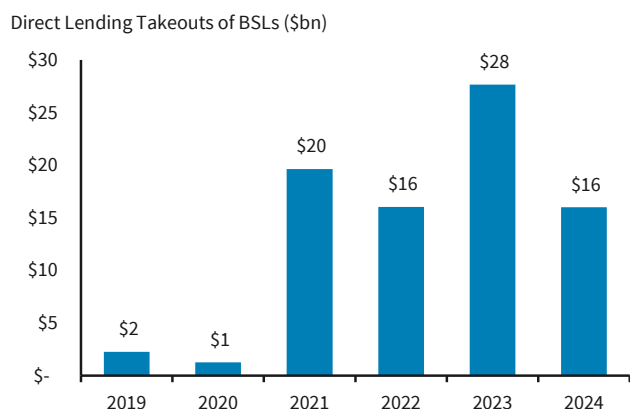
Finally, private credit continues to seek for opportunities to insert itself into public leveraged finance markets. As discussed in [Private Credit: You have to give something to get something](#), the two markets have become increasingly competitive in recent years, with private credit already having refinanced over \$80bn of BSLs since YE19 (Figure 21). With an abundance of dry powder from distressed/special situations-focused strategies waiting patiently on the sidelines (Figure 22), there are outside avenues through which lender-on-lender violence can be enacted. While creditor-on-creditor violence has been more of a theme in public credit markets, the highly publicized Pluralsight restructuring showed recently that private credit is not completely immune to the same forms of aggressive LME.⁶

As we have stated [previously](#), we believe that the susceptibility to creditor-on-creditor violence in private credit is comparatively lower than the BSL market because of the lack of multiple classes of debt in most transactions (see [Where did all the 2nd liens go?](#)). However, it is certainly still possible, as sponsors and corporates are likely to examine all options in times of stress, and similar to public markets, dropdowns and removal of assets remain possibilities even with a

⁶ "A messy loan restructuring highlights risk lurking in private credit" FT, July 10, 2024 (link)

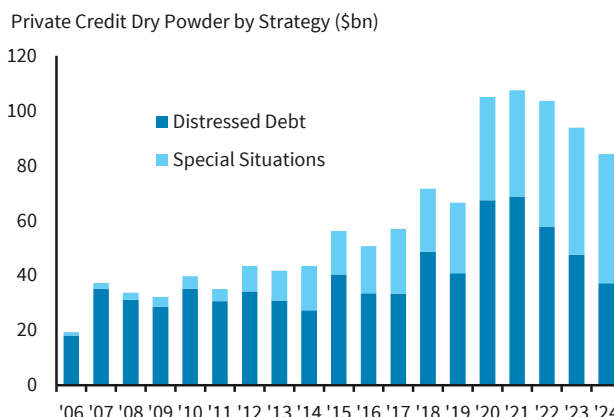
single class of debt. For these reasons, we believe there are several separate but interrelated signs that point to a continuation of contentious LME.

FIGURE 21. Private credit continues to capture share from the BSL market



Source: LevFin Insights, Barclays Research

FIGURE 22. Distressed-focused funds have an arsenal of dry powder ready to be deployed



2024 data through June.
Source: Preqin, Barclays Research

So what does this mean for recoveries?

The natural continuation of this discussion pertains to recovery rates. As discussed in [Some things are worth stressing over](#), ratings agency recovery rates are produced in a systematic way, typically by using an instrument's trading price at a fixed amount of time post-default event. Because of this, published recovery rates tend to appear higher for distressed exchanges than those on regular-way defaults.

While this does allow for apples-to-apples comparisons of how bond and loan prices initially react to defaults, we do not believe that these metrics should be equated with *ultimate* recovery, particularly in the case of distressed exchanges, which can occur multiple times over. To that end, a recent study⁷ by S&P found that re-default (or issuers with multiple defaults) was nearly five times more likely after a selective default (such as after a distressed exchange) than after a general default within a 48-month period post-default. It also found that repeat defaults occurred after roughly 35% of distressed exchanges within 48 months.

This implies that issuers that "kick the can" are unlikely to kick it very far. Moreover, it tells us that recovery rates on distressed exchanges should be viewed as an "interim" recovery, until the ultimate recovery is realized. S&P produced a separate study in April⁸ showing that recoveries following a re-default tend to be lower than the initial default (although this data contains more than just distressed exchanges). Their calculations showed that term loan recoveries fell 7pts in the subsequent default (from 71% to 64%) and that senior unsecured bond recoveries fell over 25pts, from 63% to 38%, on average.

Despite the deterioration in re-default recovery rates, this is not to say that distressed exchanges provide *zero* benefit to issuers facing fundamental stress. Buying time with LME can provide companies with a short-term liquidity solution, which can allow an issuer to avoid

⁷ "Buying Time Post-Default with Private Credit" *S&P Global*, December 2023

⁸ Credit FAQ: The Rise of Repeat Defaulters, *S&P Global*, April 11, 2024

layoffs and help creditors mitigate near-term losses. However, the ways in which LME has infected leveraged finance market has bred contempt among lenders and created a marketplace where the largest players have an outsized share of negotiating leverage.

Distressed exchanges are also unable to fully cure a business of any secular headwinds or intrinsic flaws. As the aforementioned article from the Duke Law Journal stated, a coercive exchange "is essentially a money grab that provides the borrower a little additional runway but does nothing to address the structural and operational issues that invariably played a large role in creating the distressed situation in the first place. What often results from coercion is a zombie company that generates only enough revenue to service its debt, limping along until there is very little left to salvage."⁹

We believe distressed exchanges and other forms of LME are challenging for the market as a whole, given that credit analysts are now allocating a larger proportion of their time to game theory rather than modeling fundamentals. While this trend may ultimately be viewed as degenerative to market structure, it remains necessary for lenders to be properly informed of the market's evolution and its consequences, particularly as the historically US-based trend starts to make its way to European leveraged finance as well.¹⁰

⁹ "Creditors Strike Back: The Return of the Cooperation Agreement", *Duke Law Journal Online*, October 2023 ([link](#))

¹⁰ Liability Management Exercises: A Transatlantic Perspective, Akin Gump, June 1, 2023 ([link](#))

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