

How Much Is a Revolver Worth?

Brian L. Kloss, JD, CPA |

A revolver is a debt instrument that many companies have lined up with a lender in the event they need to raise cash and deploy it quickly—also known as working capital. Revolving debt is often a cheaper short-term financial solution for management teams. If a company draws on its revolver, that debt then attains status in its capital structure. Several exploration and production (E&P) companies have drawn down on their revolvers this year—a trend we think is starting to gain momentum in the energy and mining industries. As crude oil prices started to slide in late 2014, it became evident that smaller U.S.-focused energy companies struggled to keep their business models intact as the oil rout continued. We wonder whether market participants understand the risk these energy companies' actions pose to their investments, because although we have seen companies draw on their revolvers during times of economic uncertainty in the past, we generally have not seen such actions with respect to commodity-related entities in an environment of falling commodity prices. For example, Chapparral Energy, Peabody Energy Corp., Linn Energy LLC and Sandridge Energy Inc. have drawn on their revolvers as commodity prices moved lower in January and February, thus forcing the bank, and in many cases the investors that hold the loan, to commit capital per the terms of the indenture at a senior level. We believe when a company accesses its revolver in these scenarios, investors in subordinated debt—and the revolver—immediately see the value of that security plummet. Therefore, a company's decision to draw on the revolver creates issues for:

1. The banks
2. The investors in the syndicated loan and/or
3. Other subordinated stakeholders

Stakeholders that become subordinated because a company draws on its revolver are impaired by the additional debt being layered on top of their claim, which potentially reduces their recovery in a bankruptcy proceeding or an out-of-court restructuring. As senior debt is added to the capital structure, recovery rates will be suppressed for all assets subordinated to the revolver given its senior lien status.

What is not intuitive with respect to the potential negative consequences of drawing on the revolver is the impact to the bank or loan investor. Due to the nature of a revolver, the bank/investor is obligated to extend credit to the borrower at the borrower's request if the company is in compliance with all terms of the indenture. Risk-off periods—as has been the case in 2016 so far—may create issues for the bank/investor, especially if the investor is a private asset manager—including collateralized loan obligations—or a public '40 act fund that is facing outflows, and must commit additional capital when there are other demands on its capital.

We believe investors have not yet fully discounted whether a revolver may be significantly impaired immediately upon being drawn due to the deterioration of a company's underlying business model, and therefore permanently impairing capital—which is the situation described above in the cases of Linn Energy LLC and Sandridge Energy Inc. What do we mean by immediate impairment of the revolver? For example, if a bank lends an energy company \$1, that loan is immediately discounted by up to 30% once the company draws on its revolver. We find this discount problematic for the lender and the broader credit market. Firstly, the significant discount leaves lenders under-reserved for these capital charges. Secondly, we think the market will be unprepared for these impairment charges.

Lastly, we're starting to see energy and mining companies draw down on their revolvers en masse at a time when commodity prices are falling, upstream production is slowing, and credit markets are tightening. In our recent blog post on [global credit quality](#), we suggested that the U.S. credit cycle is in a comparatively more mature stage, which means lenders are tightening their standards and causing the default rate to inevitably

creep up. Therefore, the credit market stands to contract relative to the U.S. economy over the next 1-3 years. We believe as credit tightens, growth in the energy and mining sectors—and in the U.S. economy to a lesser extent—will correspondingly slow down as well.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.

©2024 Brandywine Global Investment Management, LLC. All Rights Reserved.

Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.