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Leveraged loans: False alarm?

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From the Leveraged Finance Fund management desk

- There has been no let-up in the negative press and regulatory headlines about leveraged loan markets and we believe there is a need to redress the balance
- The prevalence of cov-lite warrants caution and scrutiny from lenders but business size and quality is high and default risks are low
- Fundamentals are largely supportive and loan yields compensate for the risk of credit loss

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance

Furore over leveraged loan markets continues – should investors be worried?

For several months now, regulators and other market commentators have been expressing concern about the state of the leveraged loan market. Recent commentary has homed in on possible systemic risks posed by leveraged lending and potential threats to global financial stability. What has prompted the growing chorus of concern (and scrutiny) over the leveraged loan market? And is it warranted?

Regulators are worried that higher leverage and looser lending standards for sub-investment grade companies – particularly if in tandem with higher rates – could trigger the next downturn. Regulators are also focused on who is lending. News that the Financial Stability Board (FSB), the global regulator, will investigate parts of the leveraged loan market has only added fuel to the fire – with its examination due to focus on (identifying the holders of) collateralised loan obligations (CLOs) and whether there is any risk of *en masse* exit or other structural fault-lines in the market.

The 'buyer beware' rhetoric has, at times, contained some misperceptions about the leveraged loan market, and been guilty of overly simplistic comparisons with conditions in 2006-2008. When it comes to assessing the risks inherent in today's global loan market, it is important for investors to be able to separate fact from opinion or claim – and everything else in-between.

How far have documentation terms been eroded in reality?

It is indisputable that around 80% of global loan market issuance is covenant light (cov-lite) but there remains a misperception that cov-lite equals no covenants. This is not the case, rather it refers to the way that the covenants are, as for bonds, now incurrence-based. This means that although today's financial tests govern the ability of a company to add debt, they are not required to be maintained at all times. The incurrence test is still a useful protection measure though, controlling as it does the pro-active increase in leverage but it has no 'bite' or applicability when leverage increases owing to a fall in a company's earnings. It is worth noting that other covenant protections, governing asset disposals, transfer of security, dividends, change of ownership, largely persist.

The ability of lenders to act early when problems first arise is nevertheless constrained from a legal perspective under the cov-lite regime. However, in a lending relationship, a borrower may still pro-actively approach its lenders and a private-side lender will be keen to hear directly from the company about planned remedial measures. There will also be a requirement for the company regularly to report to its syndicate.

In addition to the conversion from maintenance to incurrence covenants, attempts by private equity sponsors, underwriting banks and law firms further, and excessively, to weaken documentary protections have not gone unnoticed by lenders.

While lenders are successfully pushing back on this sort of behaviour, lately, even in liquid markets, they still need to be careful that 'loopholes' – that could effectively impair the first lien position or enforcement rights of the senior secured lender – are not placed in the legal terms without knowledge and that financial metric 'modifications' that are used to make companies appear more creditworthy to investors, are carefully considered and looked at with a sceptical eye. The use of so-called 'add-backs' to earnings before interest, taxes, depreciation and amortisation (EBITDA) – the addition to earnings of non-recurring expenses, for example, that allow borrowers to take on more leverage and 'grow into' their capital structure – is one example of where cynicism is required, 'exceptional items' sometimes being anything but one-offs.

In our paper, "Navigating the 'new normal': Cov-lite lending and beyond", we highlighted the specific changes that have crept into loans over recent years and why lenders need to exercise vigilance when evaluating each loan issue and subject issuers to rigorous stress-testing. We also examined loan default risk and recoveries in the era of cov-lite lending, concluding that investors may need to take more into consideration than the state of covenants and also treat 'average' historical recovery data (which is limited) with some caution, when looking to accurately project what will happen to recoveries should defaults pick up from current lows. This is particularly true in the European market where restructurings will typically be idiosyncratic, privately-negotiated affairs.

Putting risk into perspective – once bitten, twice shy?

Most of the growth in cov-lite loan volume has been post-financial crisis, so the implications of today's looser lending standards have not been adequately tested as we move closer to the next downturn. Careful analysis and scrutiny of each transaction is therefore warranted. Nevertheless, the developments in the leveraged loan markets do not bear the hallmarks of the sub-prime mortgage market and to suggest that may be the case is misleading and alarmist, in our view.

Leveraged lending is a highly analytical decision, made by an experienced credit manager, to make a loan to a sub-investment grade company – often one that is large, well-known, global – with visible cashflows and measurable presence. This is in contrast to the opaque sub-prime mortgage securities market, pre-crisis, where managers of mortgage asset-backed securities had limited visibility of the underlying creditworthiness of individual mortgage-holders nor exercised any discretion in selection. In the loan market, lenders undertake extensive due diligence on individual borrowers and their loan documentation before deciding to lend. In the sub-prime mortgage market, individuals with poor credit history and uncertain income were allowed to borrow without oversight, taking out 95% or 100% loan-to-value mortgages.

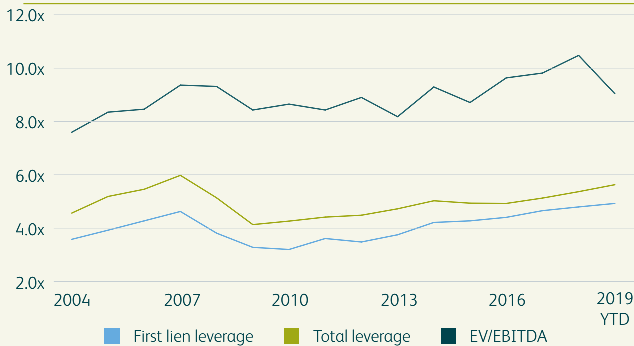
Differences aside, higher corporate leverage and looser lending standards are not to be taken lightly. In this context, public commentary by the US Federal Reserve, the European Central Bank (ECB) and the Bank of England – that would indicate their careful attention to the state of play in the corporate loan world – is arguably helpful in shining a light on the most egregious behaviour. We discuss leverage in more detail in the next section and take a closer look at today's global leveraged loan market and how it differs from pre-crisis times.

Then and now: How European loan markets compare with pre-crisis conditions

Loan structures: A closer look at leverage

First lien leverage for new loans was 4.9x in the first quarter of this year, slightly above pre-crisis levels (2007: 4.6x) according to S&P LCD, with leverage having increased gradually over recent years. Total leverage is below pre-crisis levels, however, standing at 5.6x at the end of the first quarter versus 6.0x in 2007.

Total and first lien leverage – new issue leverage contained with total leverage below pre-crisis levels

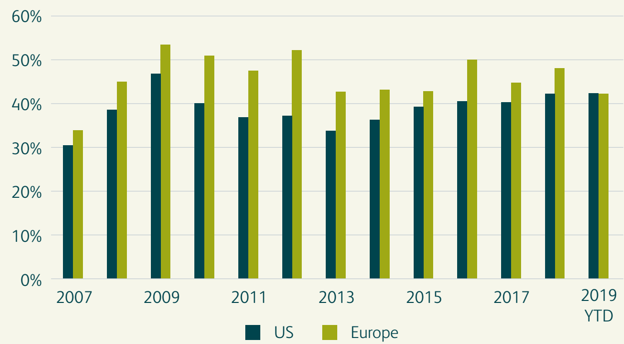


Source: S&P Capital IQ LCD, as at 31 March 2019

History – in the US at least – has shown that the presence of junior debt in a loan structure will lead to a higher senior debt recovery rate on default, according to S&P, so the prevalence of senior, loan-only structures has raised concern that first lien lenders will be exposed to losses through lower recoveries when the cycle turns. In Europe, things are more complex. Loan restructurings are usually privately-negotiated out of court and it is not always helpful to have another class of debtholder in the discussions even when they have no economic value left. Indeed, in some countries, it can delay the conclusion and optimal outcome of a workout for first lien lenders.

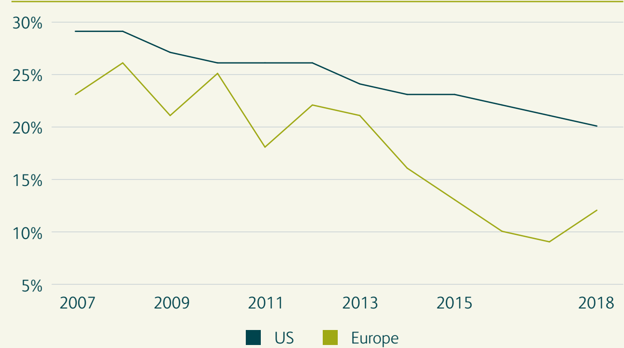
Furthermore, history may not repeat itself in the next downturn owing to higher average equity contributions from sponsors in new loans compared to pre-crisis – 48% in value in Europe and 42% in the US – providing an additional margin of safety and downside protection for lenders. A closer look at capital structures reveals that the incidence of all-senior structures is higher in Europe while in the US, junior debt makes up a higher proportion of the debt cushion that sits beneath new first lien loans.

Average equity contributions to buyouts – higher equity cheques providing larger valuation buffer to senior lenders



Source: S&P Capital IQ LCD, as at 31 March 2019

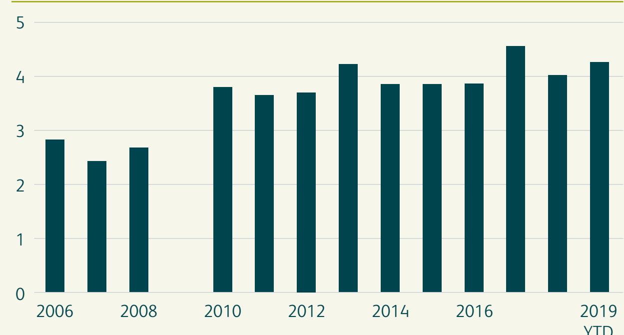
Debt cushion of new-issue loans*



Source: S&P Capital IQ LCD, as at 31 December 2018

* Reflects the share of debt that is subordinated to first lien term loans

Interest coverage ratios (x) – comfortably high relative to 2007



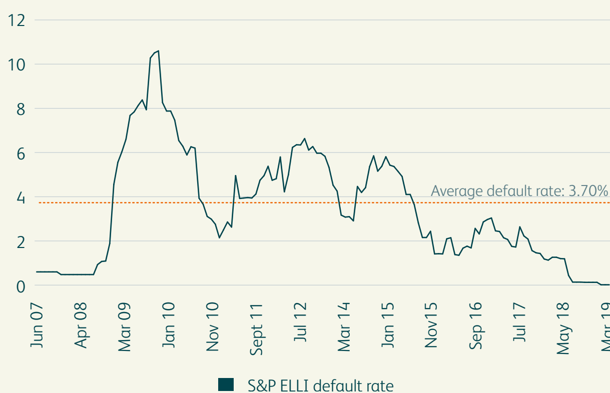
Source: S&P Capital IQ LCD, as at 31 March 2019. Interest cover is EBITDA to cash interest cost

Borrowers and risks are well-understood

Companies in the borrowing population are not only larger than that of five years ago but are often major industry players or best-in-class companies that provide lenders with regular financial reports and other information to attest to their financial health. Loans are also individually rated by managers and often by public agencies too.

Idiosyncratic risk has been rising across the corporate credit market markets generally, but loan default rates in Europe are extraordinarily low – far below the historical long-term average for the market.

European loan market default rate – default rates are extraordinarily low



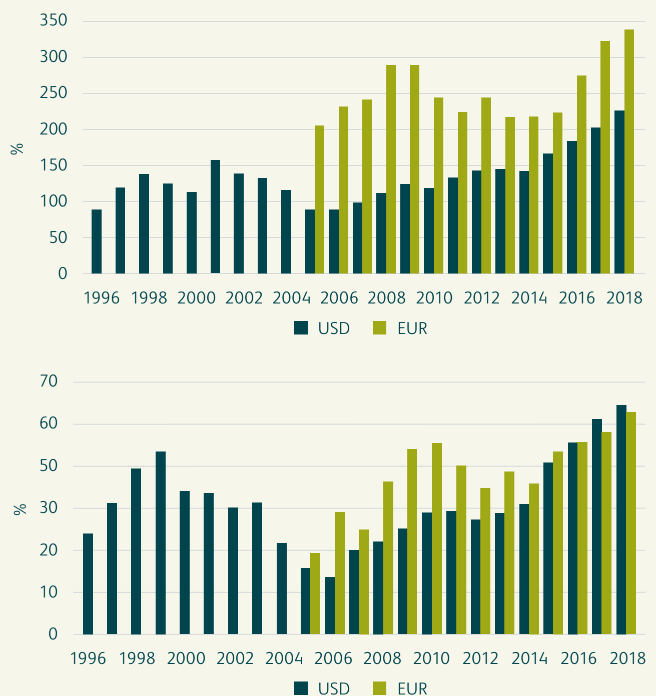
Source: S&P Capital IQ LCD, as at 31 December 2018

Growth and size of the market

The growth of the broadly-syndicated €300 billion[1] European loan market and the $1.2 trillion[2] US loan market is not as 'explosive' as is claimed and both markets are similar in size to their comparable high yield bond markets, respectively. Indeed, it is rather the high-grade market that has seen the relatively greater leveraging and growth. The European investment-grade credit market, which has roughly doubled in size over the last ten years has seen a deterioration in credit rating quality alongside its 'rapid' growth over the same period, with lower-rated BBB names now accounting for around 45% of total issuance, with a quarter of a trillion dollars' worth of single A bonds having migrated to BBB in 2018 alone – the second-highest amount post-crisis.

The weakest of the BBB universe, the BBB- population, is nearly as big (70%) as the whole of the high yield corporate universe.

Overall BBB (first graph) and BBB-(second graph) bond as a percentage of high yield universe for US dollar and euro-denominated non-financial credit



Source: Deutsche Bank, Bloomberg, ICE BofAML, as at 31 December 2018

Observers often reference the rapid growth of the loan market but fail to make the important distinction between actual growth of new loans and refinancing activity in order to get the 'true' growth rate. The average annual growth rate of the outstanding loan market has been a modest 7% since 2008[3].

[1] Source: The Credit Suisse Western European Leveraged Loan Index (CS WELLI) puts the size of the market at €286 billion ($323 billion)

[2] For the US, the Credit Suisse Leveraged Loan Index (CS LLI) is approximately $1.24 trillion in size. However, not everything is captured by the indices, this being a private market, with both the US and European markets at least 30% larger

[3] Source: Loan Syndications and Trading Association (LSTA)

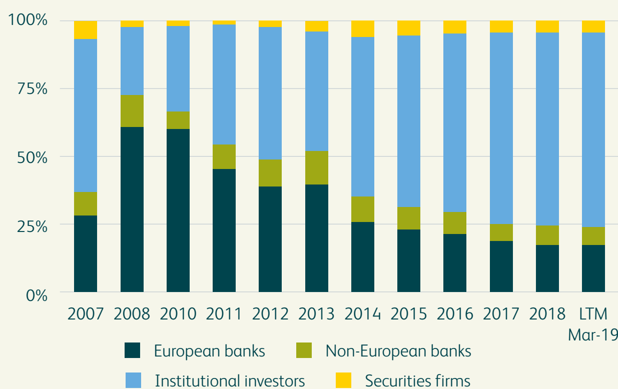
Stability of investor base provides anchor of support

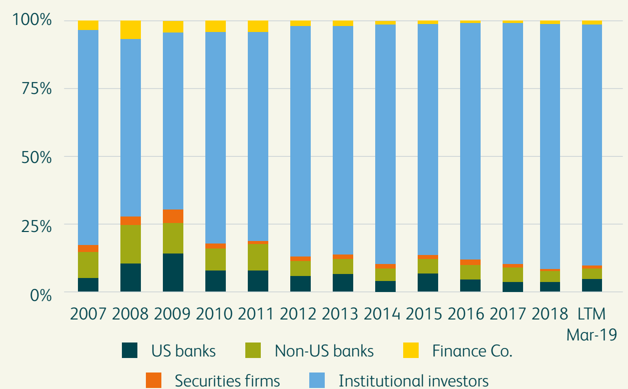
Global risk factors have potential to create extreme volatility across markets exposing investors to losses, but a 2008-type event is not anticipated in the global loan market, thanks to the nature of the investor base.

Institutional investors, insurers, pension schemes, CLOs and banks, make up the lion's share of the buying base. Even in the US where there is Retail (mutual fund) investor presence, it is modest (circa 15%). Importantly, mark-to-market leverage is not a pervading feature of the investor base like it was in 2007-8 via the Total Return Swap lines of investment banks. The triggering of enforced deleveraging price-points was a key component of the distress the loan market experienced in the crisis.

It is estimated that the CLO share of the market – specialised investment vehicles that package up loans (offering diversified loan exposure by both issuer and industry) and apportion into tranches according to their underlying credit risk – is circa 40% in Europe (and 65% in the US). These are closed-ended, non-mark-to-market, long-term asset-holders that create stability in the investor base.

The changing composition of the European and US primary loan markets (by investor type) – more stable, less levered investor base

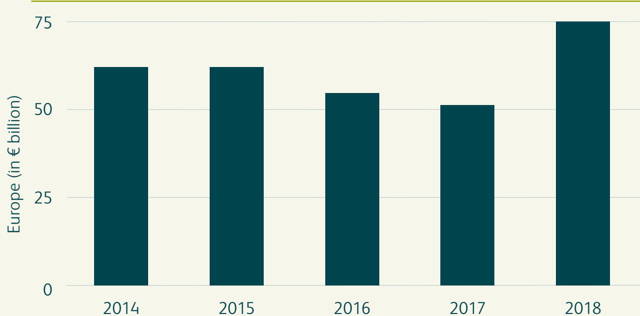




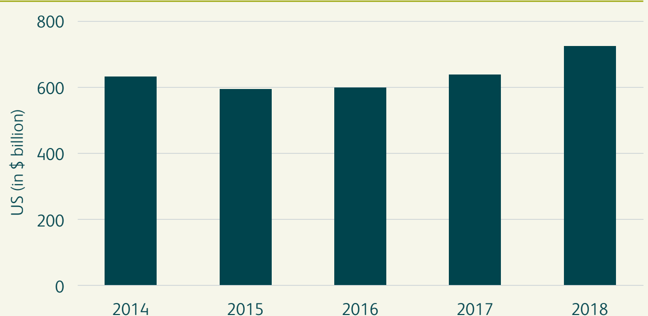
Source: S&P Capital IQ LCD, as at 31 March 2019

The European loan market has been reasonably liquid since the investor base began to diversify 15 years ago, and thanks to the ongoing maturity of the investor base, now including plenty of non-CLO, long-term institutional capital, the liquidity situation for loans has arguably improved. While not as liquid as the US, the European loan market is reasonably active in two-way trading.

Annual European and US secondary trading volume – improved secondary market liquidity



Source: Refinitiv, as at 31 December 2018



Source: LSTA Trade Study, as at 31 December 2018

Do CLOs create undue risk?

Regulators have also expressed concern that some loan investors, particularly CLOs, may also create undue risk. While the desire to have greater visibility on all aspects of the loan market should be encouraged, are the concerns justified?

CLOs are closed, long-only vehicles with term-funding and no marking to market of assets or inherent market-based triggers, built to withstand loan defaults and downgrades. CLO portfolios are subject to credit quality tests, imposed by rating agencies as well as portfolio managers. Under regulatory scrutiny, investors' monitoring practices have recently been raised. The 'Simple, Transparent and Standardised' (STS) regime, implemented in Europe at the start of this year, sets out certain requirements for European-regulated investors in securitisations to evidence detailed due diligence. Similar rules are being imposed by the Japanese regulator, the FSA, to ensure adequate assessment by CLO investors of underlying loan collateral.

CLOs are also predominantly AAA-rated – representing at least 60% of the capital stack – meaning that moderate credit rating quality downgrades should not lead to forced selling by the institutions that hold these tranches. The main holders of CLOs, which are banks, importantly, have better capital and liquidity buffers in place, compared to pre-crisis, to absorb any unexpectedly high losses. CLO holdings by these investors are also typically held to maturity not marked to market so forced selling or a fire sale-contagion scenario is unlikely, as US Fed chairman Jerome Powell explained in testimony before the House Financial Services Committee[4].

It is worth pointing out that CLOs performed very well during the 2008 financial crisis, and suffered minimal losses compared to other fixed income asset classes. The cumulative 25-year default rate for CLOs stood at 0.38% – with no recorded defaults on AAA or AA-rated CLO tranches[5]. In terms of diversification of loans underlying the CLO – the LSTA[4] recently noted that "...CLOs must meet strict diversification requirements, with most single industries limited to 10% of the total portfolio" and "single obligors can represent only 0.5% to 2.0% of the total loans underlying a CLO."

Investment risks and opportunities

As with every asset class, leveraged loans feature some potential investment risks, including:

Credit and default risk: This is sub-investment grade lending to leveraged companies so over time, signs of credit deterioration – potentially leading to downgrades and even defaults – are likely to appear. This risk, however, is partly mitigated by the senior-secured nature of the loans, which ensures the lenders receive priority repayment in the event of a default.

While the risks should not be underestimated, our expert teams make the most of their rigorous research and analytical skills to identify – and mitigate – potential risks before investing. It is important to note that European loans, unlike high yield bonds and to a far greater extent than US loans, are private debt instruments and lenders receive information on borrowers that is not available in the public domain. This helps well-resourced managers with dedicated private loan analysts and access to a large range of lending opportunities, to deeply analyse borrowers before investing and therefore to be highly selective, minimising defaults and losses.

Selectivity on which loans make it into a portfolio is very important. M&G has declined around 60% of all the deals it has been shown, enabling it to demonstrate a much lower level of defaults than the overall market.

Prepayment risk: Loans are generally prepayable on demand without penalty, so investors face re-investment risk where a borrower chooses to repay their debt early. The annual prepayment rate in Europe is currently at around 20%. To counter this, it is important to invest in the asset class through a manager with strong access to loan assets.

Liquidity risk: While loans are more liquid than other forms of private debt, they are less liquid than the listed bond and equity markets so come with a degree of liquidity risk. This risk is created both by longer settlement periods and by times of market stress, which can make it harder to trade or sell loans. Large pooled funds offering regular dealing dates can partially mitigate this risk.

[4] As cited in the LSTA's "Point-by-point rebuttal to Das's March 2 op-ed in Bloomberg Opinion"
[5] Data source is S&P as cited in the LSTA's "Point-by-point rebuttal to Das's March 2 op-ed in Bloomberg Opinion"

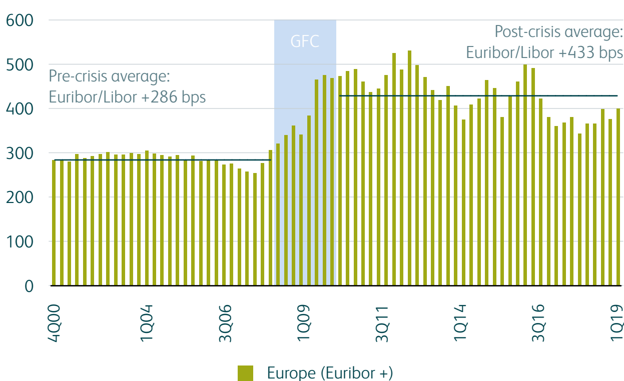
Are lenders being compensated for the risks?

The investment opportunity to lend to large companies on a senior secured basis, given the current pace of M&A activity, remains a decent one in our view. The key thing is not to be a forced buyer – either of weaker companies that might not fare well in a downturn or of strong companies with healthy cashflows whose documentation fails to protect the pre-eminent status of the first lien lender adequately.

The press commentary on the leveraged loan market has certainly commanded attention, but the key features and advantages of loans have been lost amid the noise. We outline these advantages below, which also serve as a timely reminder of the merits of the asset class for investors:

High real and relatively stable returns: European loans produce returns of Libor +350 to 400 basis points (bps) per annum over the medium term (ie three to five years), which are generated with significantly lower volatility than comparable asset classes. A selective lender is rewarded for its senior secured risk at spreads near-double those of pre-crisis times, as can be seen in the chart below, and 67 bps wider than the (largely unsecured) high yield bond spreads at the end of the first quarter.

Pre- and post-crisis spreads – loan pricing significantly higher than pre-crisis



Source: S&P Capital IQ LCD, as at 31 March 2019

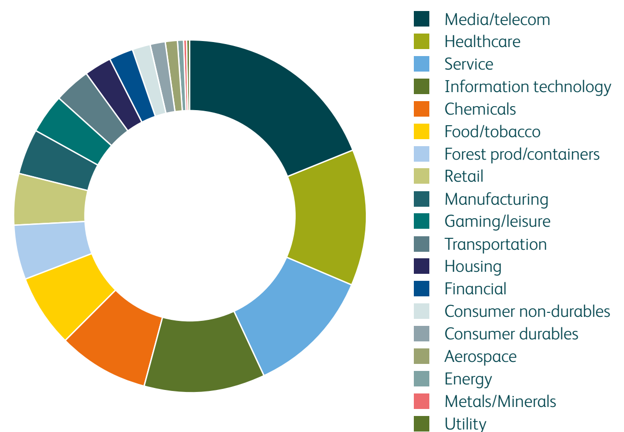
Senior-ranking security over a borrower's shares and assets: If the borrower defaults, senior lenders receive repayment ahead of junior creditors, significantly enhancing recovery rates and minimising credit losses.

Low interest rate duration: Loans are floating rate instruments with coupons linked to a short-term reference rate, such as three-month Libor, protecting investors against the impact of rising interest rates.

Liquidity and short ramp-up periods: Loans offer an active secondary market and therefore provide greater liquidity than most forms of private debt.

Diversification: With over 300 different issuers, the European leveraged loan market gives investors exposure to a diverse range of industries with limited crossover to other markets.

European leveraged loans – a large deep market



Source: Credit Suisse, as at May 2019. CS WELLI constituents by industry type based on size of issue

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