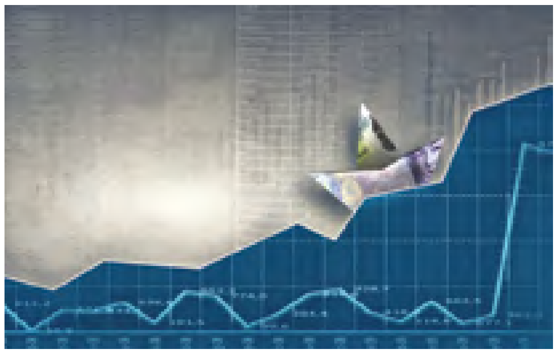
Leveraged loans: Untested waters

The leveraged loans market is becoming bigger – and riskier, says Andrew Cole, head of multi asset at Pictet Asset Management



The leveraged loans market is booming: the first half of this year, $800 million of such debt was issued globally – more than in the whole of 2015, and over double the amount in 2008.

The appeal is clear. For companies, it is an attractive source of financing at a time when the global economy is holding up well and many banks remain reluctant to lend. For investors, the returns have been relatively high, with a lower volatility than high-yield bonds. It also chimes in with the broader boom in private – rather than public – assets.

But, as the credit cycle enters its later stages, we believe there are reasons for caution. In its current shape, the leveraged loans market's ability to withstand jolts is largely untested. This is particularly worrying as issuers' leverage is rising while credit protection is weakening.

So far this year, 57 per cent of new leveraged loans issued have been 'covenant lite' – featuring less protection for the lender and giving more flexibility to the borrower in areas like tests on collateral, leverage, payment schedules, etc. A decade ago, the proportion was virtually zero.

Debt-to-EBITDA levels on US leveraged buyout (LBO) deals have also been rising: the share of LBOs levered at six times or higher stood at nearly 50 per cent in 2017 from 30 per cent in 2013.

Such deterioration in the quality of credit has two consequences. One, it will likely lead to lower recovery rates in case of default as the weaker covenants can enable companies to issue more debt than normally would be the case. Not only does that reduce their ability to pay, but it also increases the risk a loan will be subordinated by future borrowing.

At the same time, credit pricing now provides little room for default. In the US – by far the biggest leveraged loan market – the average spread at loan signing date has dropped significantly to just 383 basis points mid-2018 from a peak of 473 basis points in March 2015.

If defaults were to rise to 5.5 per cent from about 2 per cent currently – which would still be far short of the 10-15 per cent rates typically seen during recessions – and the recovery rate dropped to 50 per cent, the excess spread would be wiped out. In other words, it would take only a relatively modest deterioration in conditions for investors to lose all the additional compensation these assets are offering in exchange for increased risk and reduced liquidity.

Admittedly, the high-yield bond market has been subject to similar trends and also currently offers investors limited compensation for the degree of risk. But its borrowers tend to be of a higher quality, with the majority BB rated, compared to B for leveraged loans.

Any asset comes with some risks, and the key to successful investment is to fully understand what those risks might be. Arguably the biggest problem with private credit is that the asset class is largely untested against adverse conditions, having not yet weathered a significant default cycle. The majority of private debt funds were created well after the financial crisis.

A further risk is that leveraged loans, a traditionally very illiquid asset class, are increasingly structured in vehicles with open-ended liquid structures, such as mutual funds and ETFs. This liquidity mismatch is likely to cause problems in a period of market stress – a fact that has already been noted by the International Monetary Fund (IMF).

Thus, as the credit cycle enters its later stages, we are mindful of the risks to the credit market in general and to its private lending segments in particular. Those investing in this asset class should be cognisant that protection is weaker and returns are lower than has been the case historically. The outlook for these products – as yet untested but likely to be highly correlated to other parts of the credit universe – is uncertain over a two to three year time horizon. And given the impact leveraged loans can have on corporate capital structures, any turbulence could have implications for other asset classes and even for the global economy more broadly.

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In association with PICTET 1805 Asset Management

Source of all data: Bloomberg, LCD/S&P Global Market Intelligence, August 2018.