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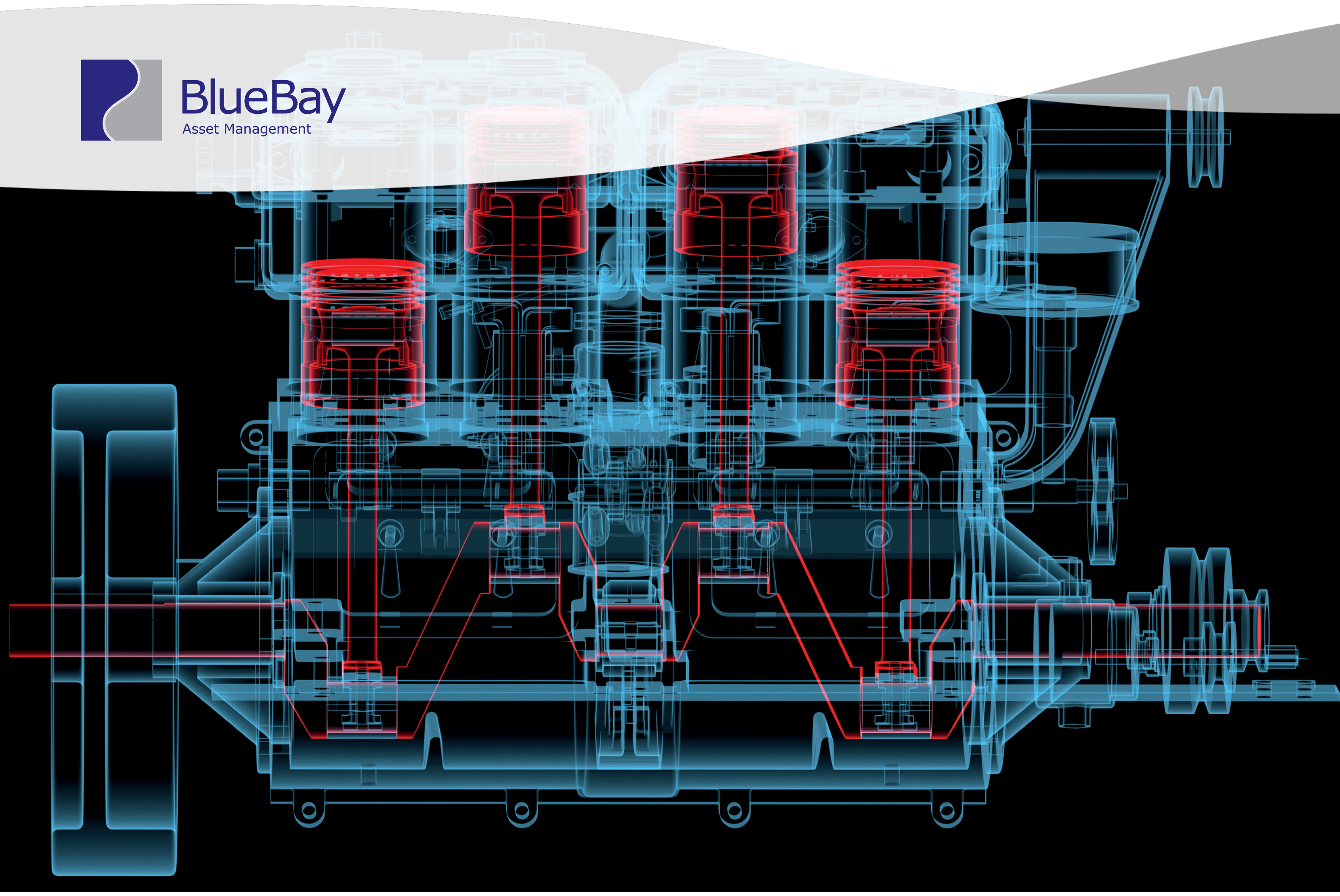

US leveraged loans – behind the scenes

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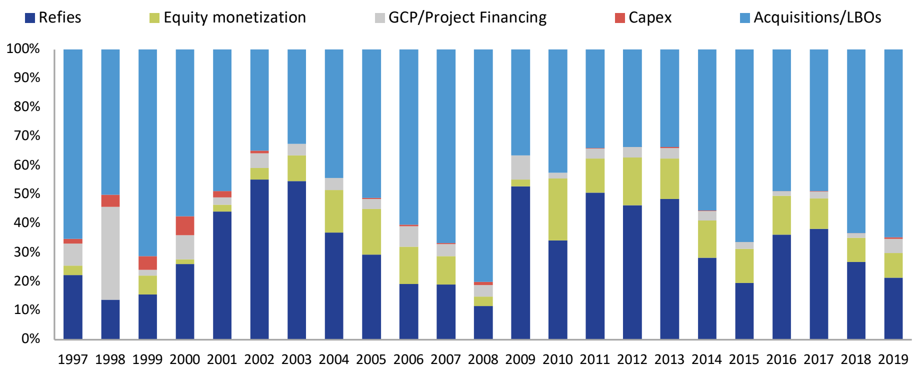
The US leveraged loan market has proven to be, until recently, resilient, despite facing a challenging environment over the past few years.

Outflows from the retail component of the US leveraged loan market have been incessant for the past year, with some USD33bn flowing out of US retail loan funds during 2019. Covenants and the associated investor protection are seemingly a thing of the past, while the loan market has taken the brunt of traditionally more aggressive leveraged buy-out (LBO)/acquisition financing over the latter part of the market cycle (chart 1).

CHART 1: LEVERAGED LOAN ISSUANCE SKEWS TOWARD ACQUISITIONS AND LBOS



Source: BofAML, as at 31August 2019

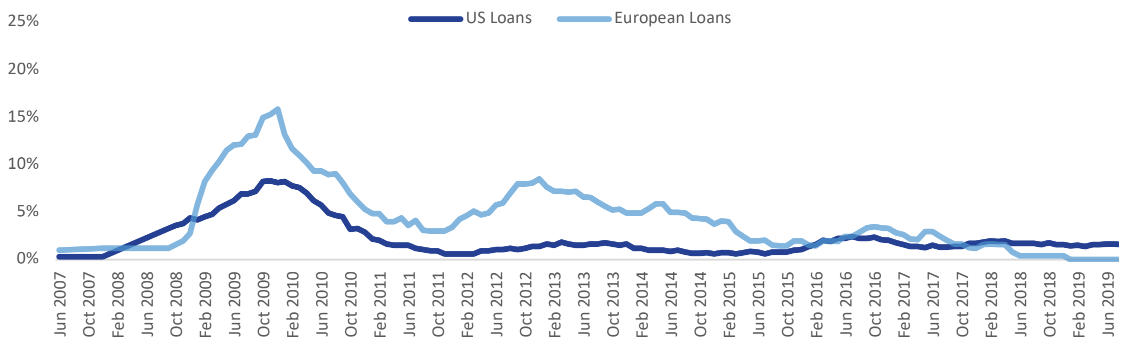
Global Asset Management

Despite this backdrop, US leveraged loans have performed admirably, posting solid gains albeit lagging the more interest-rate sensitive (and volatile) high yield (HY) bond market. In recent weeks, however, cracks have finally begun to show and loans have notably underperformed their HY bond counterparts.

What has caused this recent bout of weakness and is it anything more than a temporary blip?

Superficially, US leveraged loan spreads appear to compensate appropriately for the main credit risk in the market – defaults. Although not quite as low as the current experience in Europe, spreads seem to account for what remains relatively low levels of defaults (currently around 2% in US leveraged loans versus a long-term average of 3.2%).

CHART 2: US AND EUROPEAN LEVERAGED LOAN DEFAULT RATES



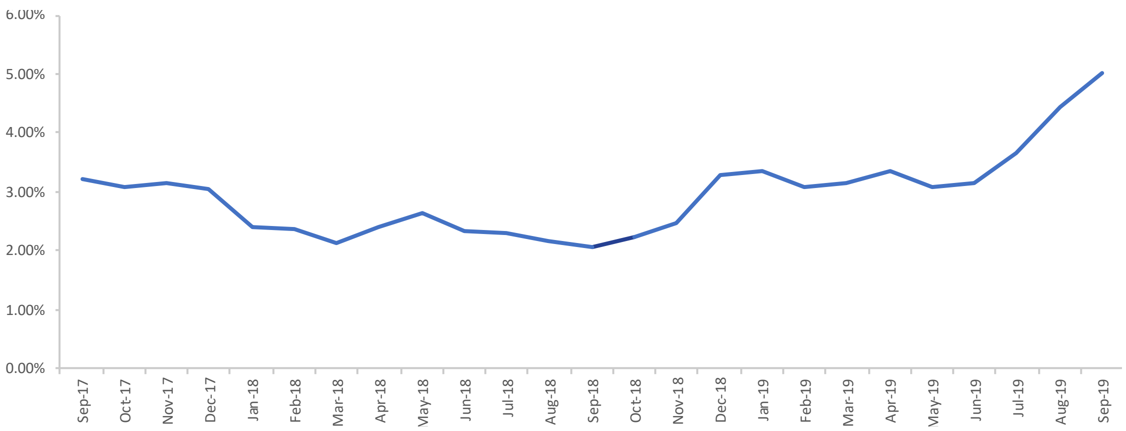
Source: S&P LCD, as at 30 June 2019

While low default rates are more desirable, they are, by definition, backward looking and have the tendency to obscure the real-time picture.

Rather it is some of the other emerging trends that give us some cause for concern and which we believe are responsible for the recent period of indigestion. When combined with more lenient (or non-existant) covenant packages, leveraged loans may not offer the same level of protection as they have done historically. Therefore, some spread readjustment is perhaps justified.

Although comforting on the surface, looking exclusively at the default rate ignores the rising idiosyncratic risks in the market. As the incidence of negative credit events grows, the distress ratio (the quantum of loans trading below 80) is beginning to show signs of increasing. Not at worrisome levels yet, but we believe the trend appears clear. One does not need physical defaults for the market to start to pay attention to emerging pressures.

CHART 3: DEFAULTS – DISTRESSED RATIO BY AMOUNT OUTSTANDING



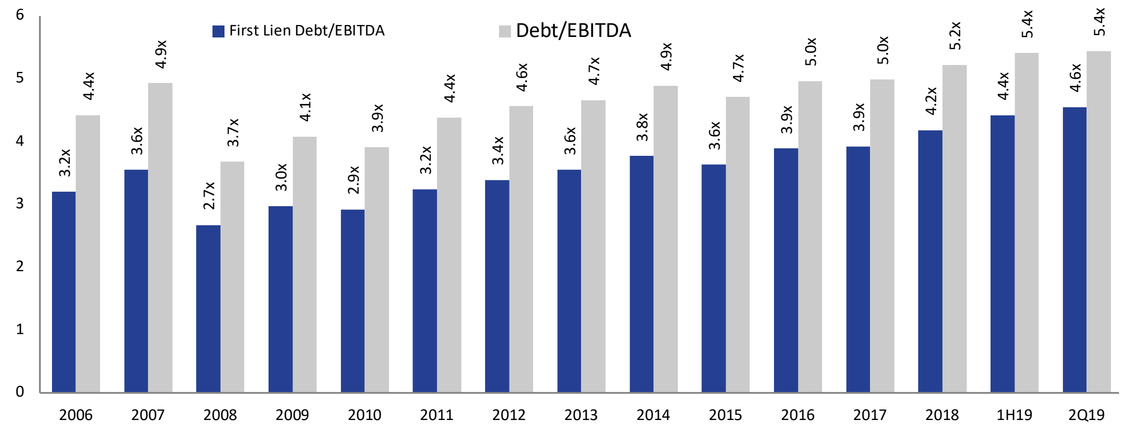
Source: S&P LCD 30 September 2019

Rising debt and earnings adjustments

Borrowing and, consequently, leverage levels are on the rise too. This is fuelled by a skew toward leveraged buyouts (LBO) and M&A transactions (as highlighted in chart 1) and the willingness of the market to accept higher levels of debt (chart 4), given borrowing rates remain relatively low and affordability commensurately high.

Debt levels are rising despite meaningful upward earnings adjustments

CHART 4: US LOAN LEVERAGE LEVELS

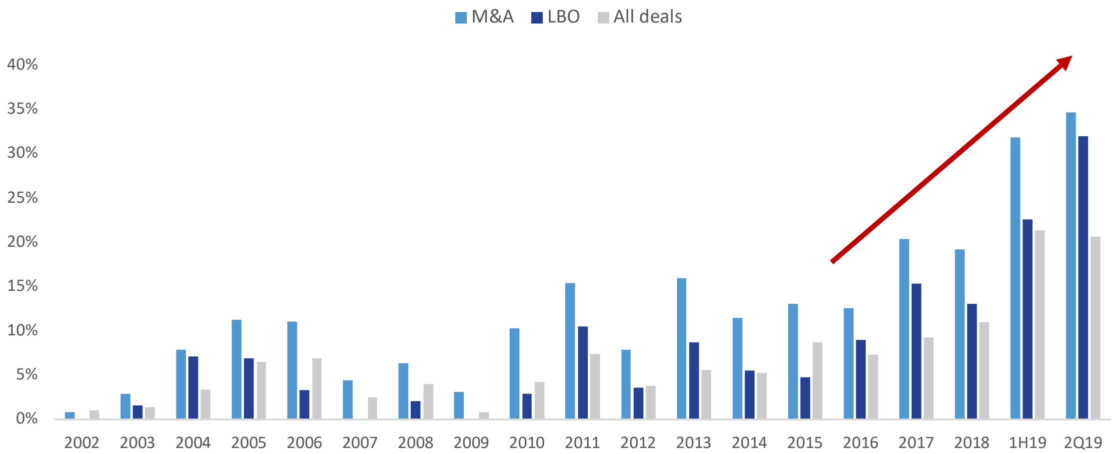


Source: S&P LCD, as at 30 June 2019

Debt levels are, however, rising despite meaningful upward earnings adjustments (which should have the effect of reducing leverage multiples by increasing the denominator in our leverage equation).

To put the level of adjustments into context, over a third of all US M&A and LBO transactions have adjusted their earnings upwards by more than 0.5x. We feel this needs careful monitoring and is as troubling as the demise of the traditional maintenance covenant. It is certainly an area our analysts are heavily focussed on when stress-testing future earnings potential to the downside.

CHART 5: EARNINGS ADJUSTMENTS IN US LEVERAGED LOANS



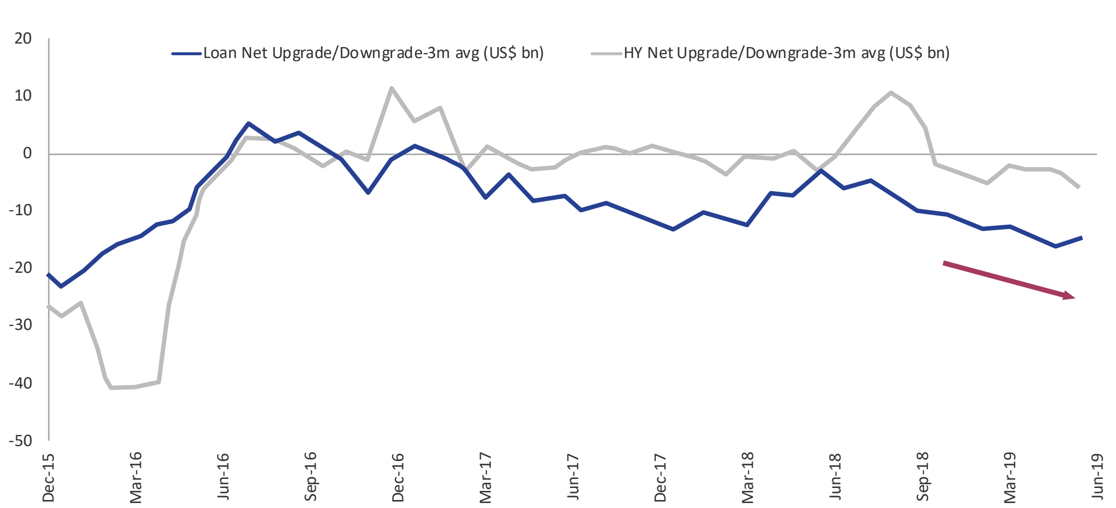
Source: S&P LCD, as at 30 June 2019

Downgrades not defaults

While defaults remain low, what is increasingly clear is the accelerating pace of downgrades in the US loan market, which in our view is much more meaningful than that currently witnessed in the US HY market.

We have recently noted a significant increase in lower-rated issuance within the US leveraged loan market

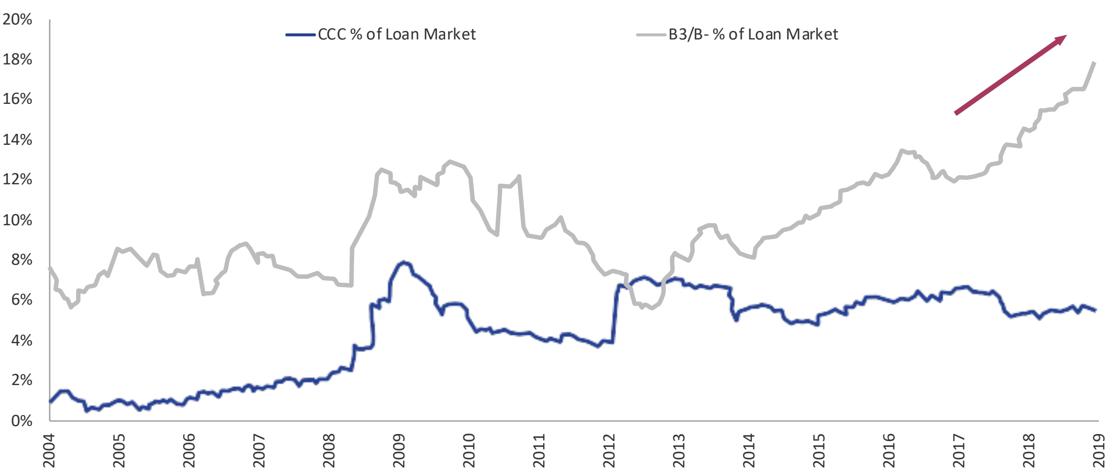
CHART 6: LOANS BEING DOWNGRADED AT A FASTER PACE THAN HY



Source: Credit Suisse September 2019

Partially as a result of downgrades, but also reflecting the trend toward LBO and M&A issuance that dominates the loan market, we have recently noted a significant increase in lower-rated issuance within the US leveraged loan market. We believe the increase in B3/B- rated securities (chart 7) is particularly noteworthy, increasing the underlying risk profile of the market and setting the scene for potential future stress – something that is of particular focus in the collateralised loan obligation (CLO) market where managers are increasingly cognisant of concentration risk in lower-rated securities rising, resulting in some pre-emptive selling it would seem.

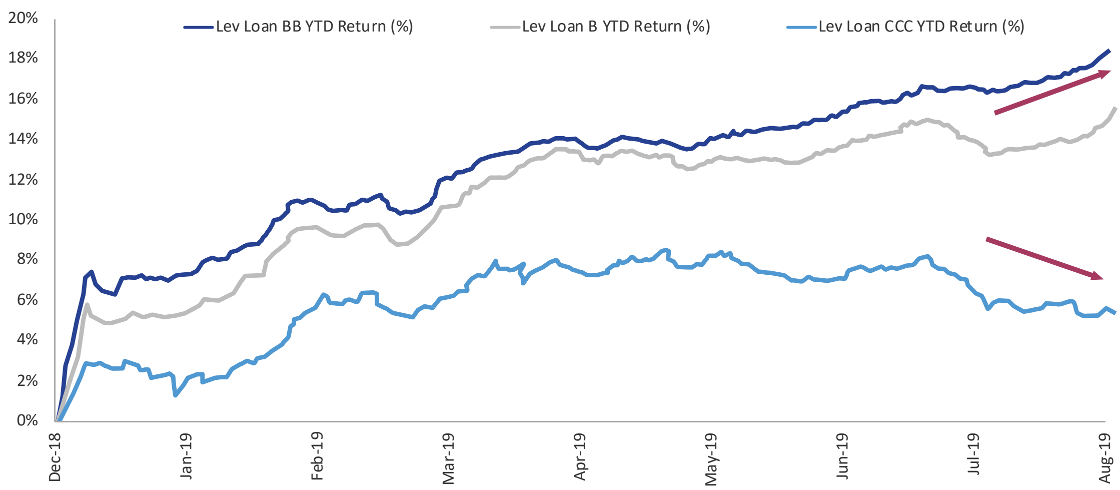
CHART 7: US LEVERAGED LOAN GROWTH SURGING



Source: Credit Suisse September 2019

Similar to the trends witnessed in the HY bond market, all of this is leading to a notable underperformance of lower-rated securities.

CHART 8: PERFORMANCE OF LOWER-RATED SECURITIES

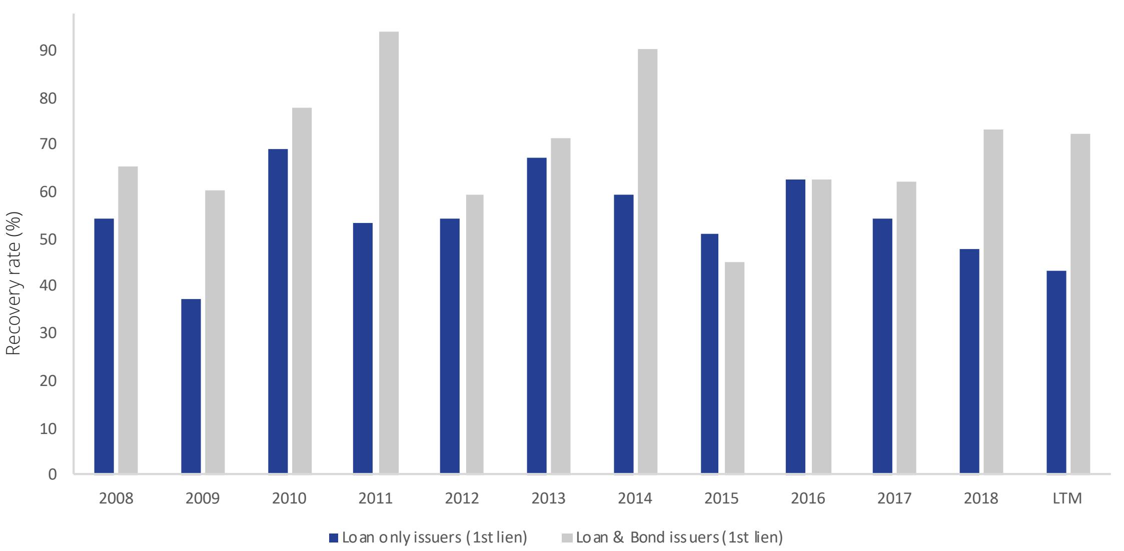


Source: Credit Suisse September 2019

There is a growing focus on recovery rates displayed by those credits that do default

Although as we have noted that actual defaults remain low, there is a growing focus on recovery rates displayed by those credits that do default. Inevitably, with diminished levels of covenant protection, when an issuer does default it is likely to provide a lower recovery level to its lenders. In addition to this, as the trend toward companies shunning the bond market and choosing to have a capital structure comprising only leveraged loans, it is worth noting that without this additional layer of subordination or protection for leveraged loan lenders, recovery rates for those companies (with only loans) are already coming in notably lower.

CHART 9: LOAN-ONLY ISSUER RECOVERY RATES



Source: JPMorgan as at 30 September 2019

While the default environment may remain relatively benign for the foreseeable future, there are clearly a variety of other developing trends worth monitoring closely and which have influenced recent price action in the loan market. With risks on the rise, caution is required. However, for the disciplined manager focussed on stock selection, environments such as these can potentially provide opportunities in equal measure.