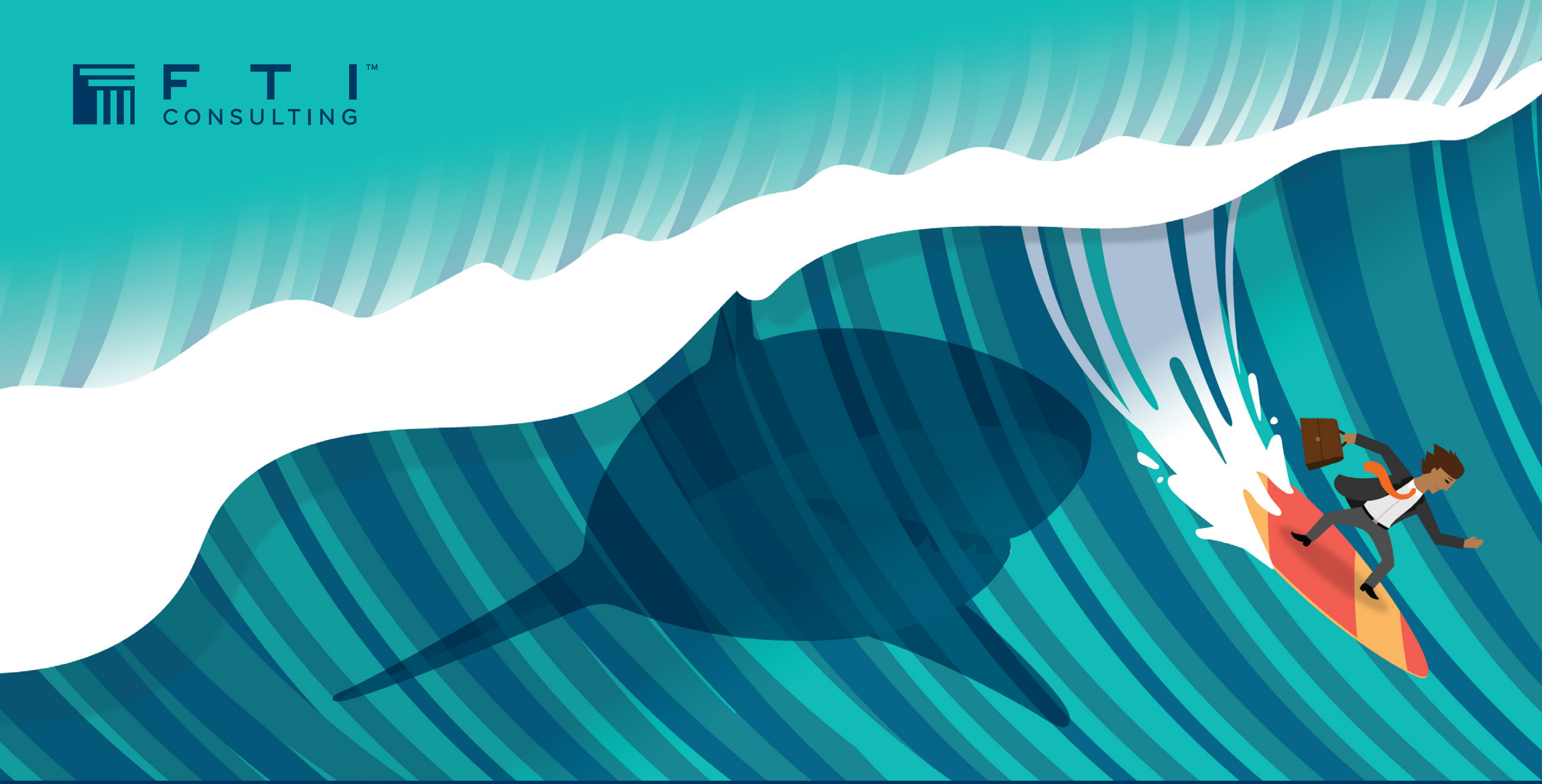


LEVERAGED LOAN RISKS AREN'T WHERE YOU THINK THEY ARE

By Michael Eisenband

Leveraged credit markets continue to dominate much of the conversation among prominent commentators and industry leaders, almost always with cautionary language attached. Some brave souls have dared to warn of an unfolding bubble scenario in credit.

But the familiar storyline remains largely intact; an abundance of global capital in search of higher returns has kept demand for the loan asset class strong even as large borrowers continue to negotiate more favorable terms and conditions that arguably are pushing the boundaries of prudent lending and eroding many traditional safeguard provisions for lenders. This dynamic has prevailed for several years without any dire consequences to speak of; so naturally, large borrowers remain aggressive in their negotiations with respect to loan terms and deal leverage. Despite some hiccups along the way, it remains firmly a borrower's market for both loans and bonds.

The latest prominent voice to weigh in on the topic is a trio of bank regulators (The Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency) in the most recent Shared National Credit (SNC) report last month. While the language and tone of January's SNC report sounds measured and bureaucratic, the message is unmistakably clear: *"Credit risk associated with leveraged lending remains elevated."* The SNC report went on to comment, *"Underwriting risks are often layered and include some combination* *of high leverage, aggressive repayment assumptions, weakened covenants, or permissive borrowing terms that allow borrowers to draw on incremental facilities and further increase debt levels."* Lastly, it commented, *"Many of these credits risks are market driven and were not materially present in previous downturns."* That is a lot to take in, and there is much more complexity to this story than a ticking bomb with a slow fuse.

Of note, the SNC report also points out that non-bank lenders, consisting primarily of collateralized loan obligations (CLOs), loan funds, pension funds and other institutional investors, account for just 22% of total loan commitments but 67% of leveraged loans and 64% of loans it considers "classified commitments" (that is, either "substandard," "doubtful" or "loss"). This contrasts sharply with loan allocations back in 2009 during the financial crisis, when non-banks accounted for just 47% of loan commitments considered classified by regulators. In other words, banks have been off-loading more and more of the riskier leveraged loan tranches over the last decade, and consequently, nearly two-thirds of leveraged loan commitments as well as loans considered sub-standard reside with non-banks that either participated in these syndications or acquired them in the secondary market. U.S. CLOs alone soon will have $700 billion of assets under management.

More concerning, the SNC report excludes loans not originated by federally supervised institutions, and, of course, that is where much of the action is these days in leveraged lending. Private credit has become the most popular alternative asset class after private equity in recent years and today commands more than $650 billion in assets globally, according to PitchBook, with direct-lending funds now leading the charge. Fundraising in private capital remains strong, and the biggest challenge facing fund managers these days is not performance-related or the shrinking number of better-quality borrowers but rather where to deploy all the money that keeps filling their coffers. Rest assured, if money needs to be put to work, it will be, and this suggests riskier deals and a continuing erosion in lending standards as long as the Fed keeps signaling to markets that it will not permit interest rates to find their natural level.

We don't want to sound like Chicken Little. It is undeniable that leveraged loans continue to perform well and that loan default rates have been very low for several years compared to their long-term track record. Thus it's understandable that demand for the asset class remains healthy, as investors are still attracted to their higher yields and priority position in the capital structure. But can anything this idyllic last indefinitely? Of course not — and we are seeing some solid evidence that the best days of this credit cycle are behind us.

While the leveraged loan default rate remains very low, it has turned higher in recent months and is expected to reach 3.0% by year-end from 1.8% at the end of 2019, according to Fitch, who expects the volume of loan defaults to nearly double in 2020. It is very likely that we have seen the lows for loan defaults in this credit cycle, so the pertinent concern now should be how far and how fast we move higher from here.

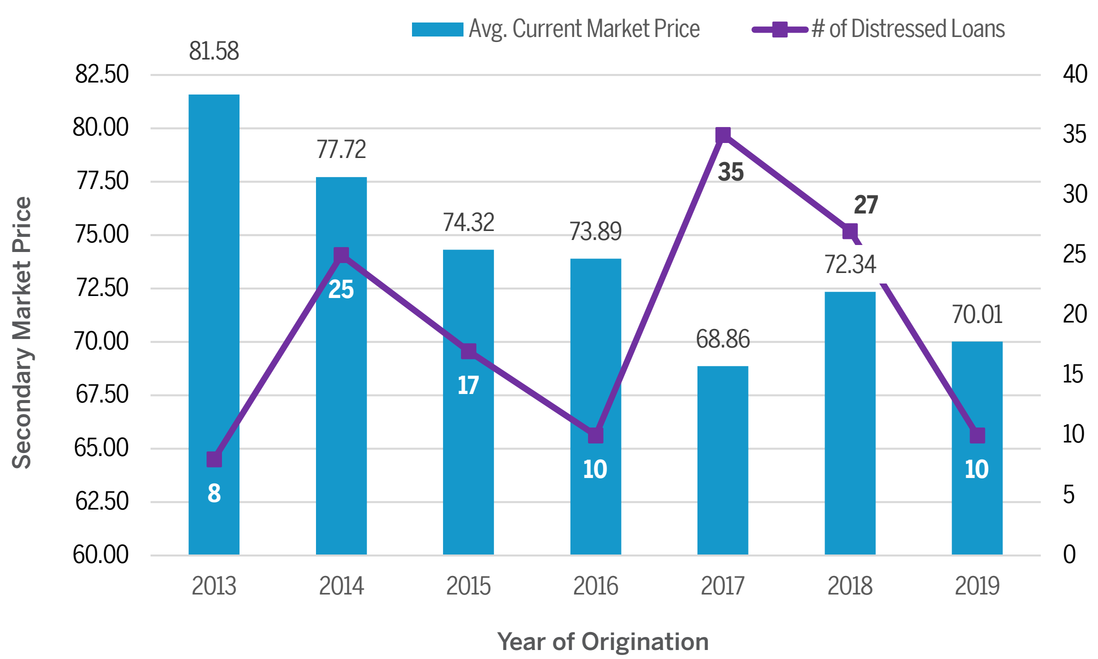
The structural seniority of secured loans is likely to be a source of false security for many lenders, as an increasing number of sponsored deals in recent years have been loan-only transactions dominated by large first–lien ("1L") term loans and relatively little junior debt. Bank of America's High Yield Credit Strategist recently revised its assumed recovery rate on defaulted leveraged loans to 50% during the next cycle, far below historical recovery rates of 75%-80% for 1L term loans per S&P, given the lower quality, fewer covenant triggers and higher leverage of those loans today compared to other periods that preceded default cycles.

Furthermore, while leveraged loan volumes considered distressed also remain low, a surprisingly large share of distressed loans was syndicated within the last three years. This suggests that loan underwriting standards have indeed deteriorated and that the impact of lax loan underwriting is becoming evident more quickly in secondary market prices.

We ran a screen in Bloomberg to identify large leveraged loans that would be considered distressed based on their current trading market prices, using a threshold market spread of at least 1200 basis points over LIBOR. In all, 132 loans to 119 unique borrowers were identified, or nearly 4% of the total number of large term loans for which Bloomberg had secondary market prices — not yet a troubling rate of distress. In all, we identified $51 billion of distressed loans, nearly 30% of which came to market in 2018 or 2019 and are trading at an average price of 70 cents, while 55% were issued since early 2017 **(Exhibit 1)**. These distressed loans went south rather quickly after issuance, it seems. Especially noteworthy, 75% of these distressed loans were made to private equity-sponsored companies, and that hardly can be a coincidence.

EXHIBIT 1

Distressed Leveraged Loans



Source: Bloomberg

The sudden outbreak of the COVID-19 virus should serve as a reminder of how unprepared leveraged corporate issuers are for a shock event. COVID-19 will be contained, but its economic impact — not just in terms of global demand but also its disruptive effect on supply chains — will remain unknown for several months. Even if its impact ultimately proves to be minimal or manageable, there are other plausible outlier events or scenarios of potentially large magnitude lurking in the background that markets and industry are mostly content to ignore and ill-prepared to handle, given the huge amounts of debt and degree of leverage that have flooded onto corporate balance sheets in the last decade. We can almost hear the excuses already.

How all of this ultimately plays out is unknowable, as the backdrop today is distinctly different than it was in 2007-2008. There is much more leveraged debt outstanding today, both in absolute and relative terms, but it is also more widely distributed among banks and non-bank lenders. Among non-bank lenders, investors have expanded beyond CLOs to include many other private investor groups globally. This diffusion of credit risk should leave large commercial banks less exposed to an economic downturn and cushion the impact on the financial system. However, it won't shield large spec-grade borrowers — especially those who have aggressively structured their balance sheets — from the consequences of their decisions to make themselves highly vulnerable to such unplanned events, unless leveraged credit markets remain forever faithful.

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