NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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High (Yield) Anxiety?

We look at high yield bonds and leveraged loans to assess the potential risks and what this could mean for the broader corporate market.

BACKGROUND

There are times when investors need to look in unfamiliar and perhaps riskier places to see which way the winds of fortune might be shifting. For example, what can conditions in leveraged markets tell us about high grade corporate bonds? Leveraged capital structures are more sensitive and vulnerable to changes in the overall financial market and as conditions change, these securities often signal danger lying ahead for investment grade bonds.

Is the leveraged market currently telling investors anything about future dangers? Certainly there are signs that fundamentals and prices are pointing toward a tough environment for below investment grade securities. Let's take a closer look at the leveraged finance markets to assess the underlying risks and what this might mean for the broader corporate market. The most relevant gauges include:

- Size of the market and ratings quality distribution
- Leveraged buyout (LBO) activity
- Loan covenant trends
- Growth of Collateralized Loan Obligations (CLOs) and
- Changes in credit fundamentals

SIZE AND QUALITY CHANGES IN THE LEVERAGED FINANCE MARKETS

Post the financial crisis in 2008-2009, the U.S. Fed and other central banks flooded the market with easy credit and liquidity, driving interest rates to historically low levels for an extended period of time. This has been a positive for borrowers, who benefited from cheaper capital and lower interest expense but less so for fixed income investors, who have often shifted into lower rated, higher yielding bonds. In light of these market conditions, the amount of outstanding high yield bonds and leveraged loans has increased substantially. Total leveraged

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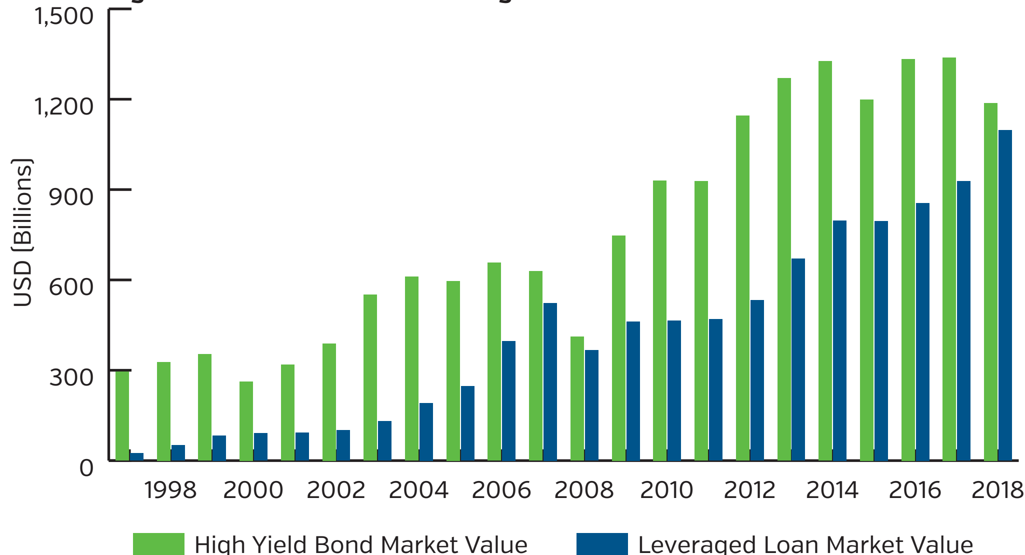
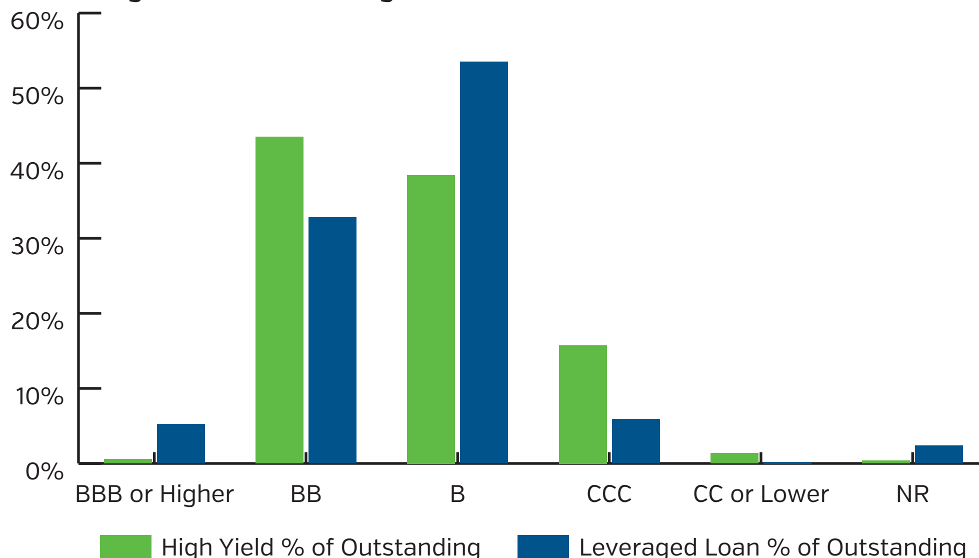
debt (bonds and loans) amounts to over $2.2 trillion, twice what it was in 2007 and ~7 times 1997's total (Chart 1). Additionally, a large percentage of lower rated securities currently comprise the high yield bond and leveraged loan markets (Chart 2) which is notable because default rates grow exponentially as ratings get progressively lower.

Chart 1. High Yield Market Par Outstanding



Source: Wells Fargo Securities, Bloomberg Index Services Ltd., S&P LCD

Chart 2. High Yield Market Ratings Distribution



Source: Wells Fargo Securities, Bloomberg Index Services Ltd., S&P LCD

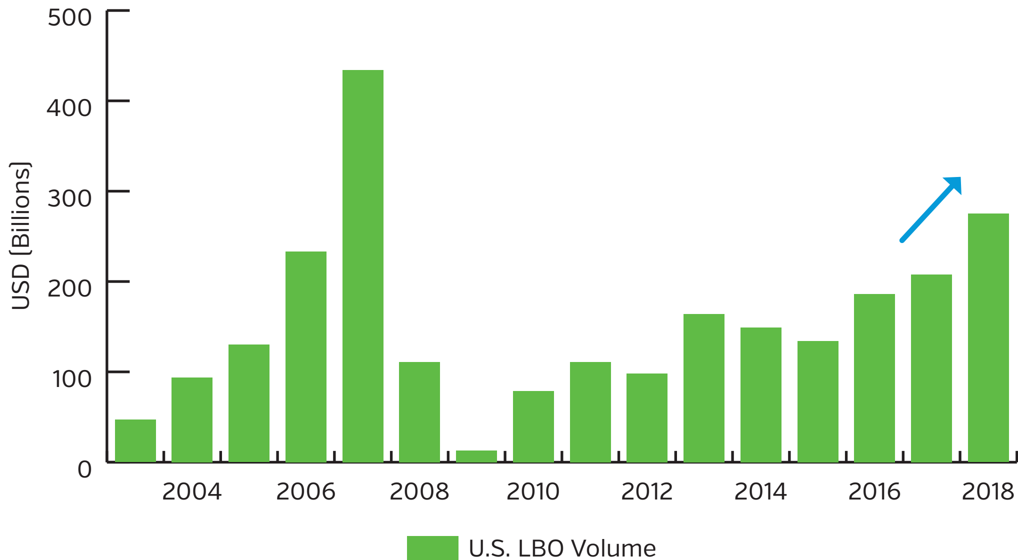
Initially, companies used easier liquidity to shore up balance sheets by paying down debt and refinancing bonds at lower rates as opposed to "shareholder friendly activities" (i.e. increased dividends or buybacks). The more time passed, however, companies shifted their focus to shareholder rewards rather than on bolstering their balance sheets. This attitude is also reflected in the increased number of leveraged buyouts (LBOs).

UPTICK IN LEVERAGED BUYOUT ACTIVITY

U.S. LBO volumes have increased to their highest levels since the financial crisis (Chart 3). Increases in LBO deal flow have often occurred during (with the benefit of hindsight) what turn

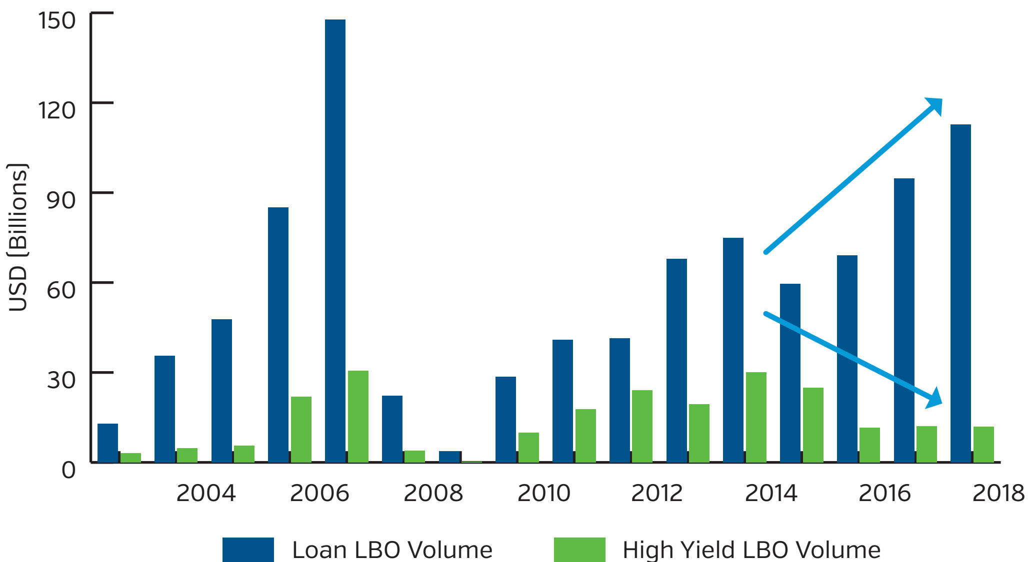
out to be market peaks. Given higher leverage and lower interest coverage these transactions tend to be more equity friendly. In a historical reversal, recent LBO-related financing has been concentrated in the loan market. The approximately $100 billion in this type of issuance dwarfs the ~$10 billion of LBO related high yield issuance in 2018 (Chart 4). Although LBO activity remains below pre-crisis levels, the steady increase over the past few years should be a concern.

Chart 3. U.S. Leveraged Buyout Transaction Volume



Source: Credit Suisse, S&P LCD

Chart 4. LBO Volume – High Yield Bond vs. Bank Loan Financing



Source: Credit Suisse, S&P LCD

COVENANTS ARE GETTING MORE PERMISSIVE AS RATING QUALITY DECLINES

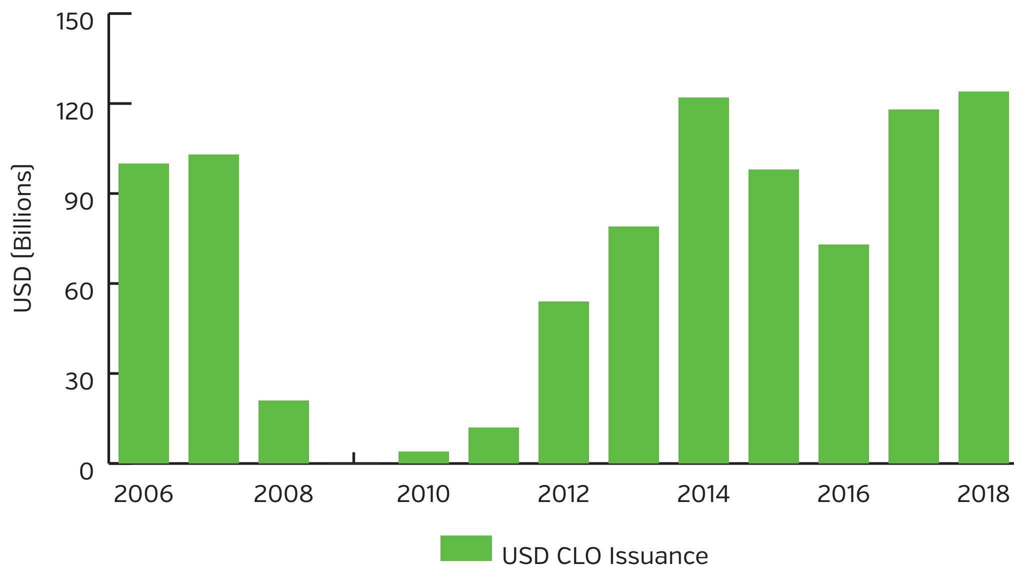
Due to the robust credit and market conditions of the past few years, there has been very little systemic distress. One area of concern has been the diminished covenant protection on new deals. Covenant-lite loan issuance remained high at ~85% of overall issuance in 2018 per S&P LCD. To gauge covenant quality, Moody's tracks numerous metrics, including leverage requirements and the seniority of lenders' claims, then scores the average strength on a scale

of 1 to 5. The higher the number, the weaker the covenant. Moody's Covenant Quality Indicator (CQI) now sits at 4.13 which is very close to the weakest score yet recorded. This is important to note because the erosion of covenant quality will likely put pressure on recovery rates as these lower rated companies could continue to have incremental borrowing capacity during the next downturn.

RECORD PACE OF CLO ISSUANCE

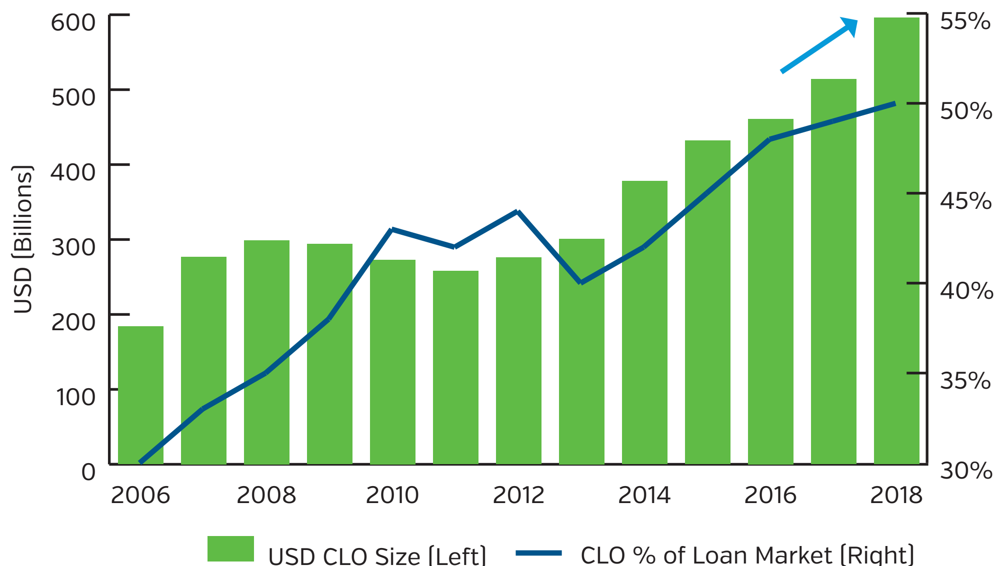
Collateralized Loan Obligations (CLOs), structured securities which are developed around bank loans, are driving demand for new bank loan products and also incentivizing easier covenants. Record CLO issuance (Chart 5) continues to fuel demand and now more than 50% of leveraged loans are placed into CLOs (Chart 6). These structures are sensitive to rating changes, despite not being marked-to-market and could raise volatility in the loan market in the event of an increase in rating downgrades and issuer defaults.

Chart 5. CLO Issuance by Year



Source: Credit Suisse, S&P LCD

Chart 6. CLO Market Statistics

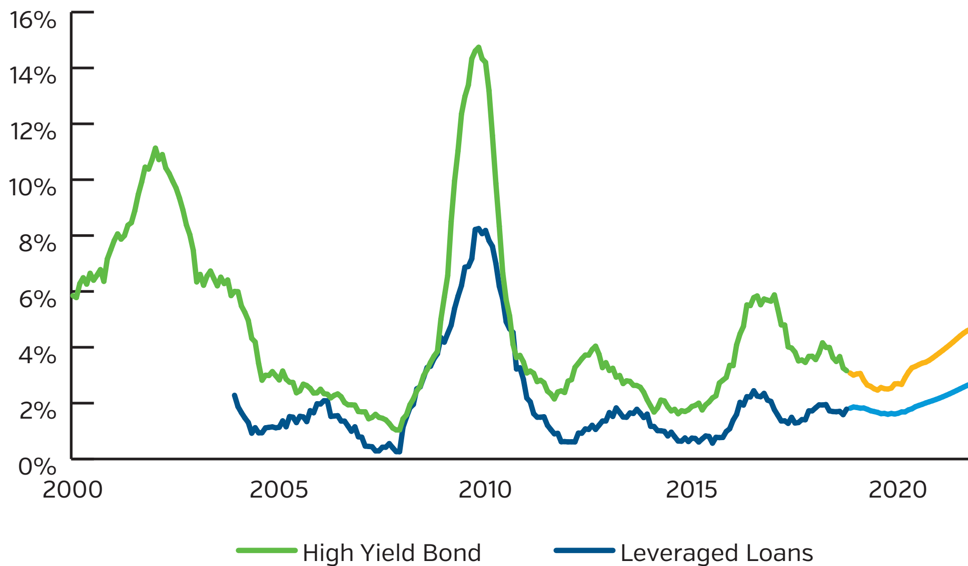


Source: Credit Suisse, S&P LCD

FUNDAMENTALS ARE STABLE FOR NOW

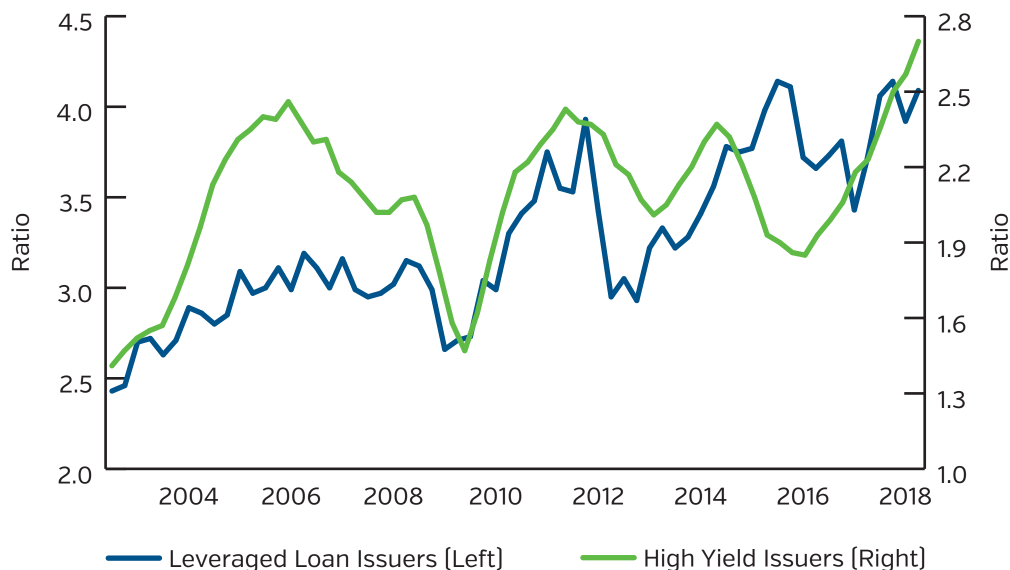
As of the end of November 2018, the 12-month trailing, issuer-weighted default rates for U.S. high yield and leveraged loan issuers stood at 3.3% and 1.6%, respectively (Chart 7). Expectations are that default risk will likely remain on the benign side in 2019, driven by low recession risk and the low likelihood of an idiosyncratic industry shock, similar to energy in 2014-2015. Although many investors have turned more cautious on the debt servicing capacity of high yield bond issuers, the low recession risk should also limit the likelihood of a significant decline in the near-term. As shown in Chart 8, interest coverage ratios have actually been improving among both high yield and leveraged loan issuers, boosted by the recent rebound in earnings growth.

Chart 7. Default for High Yield Bond and Leveraged Loan Issuers



Source: Moody's, S&P Capital IQ LCD, Goldman Sachs Global Investment Research

Chart 8. Median Interest Coverage Ratios for High Yield Bond and Leveraged Loan Issuers



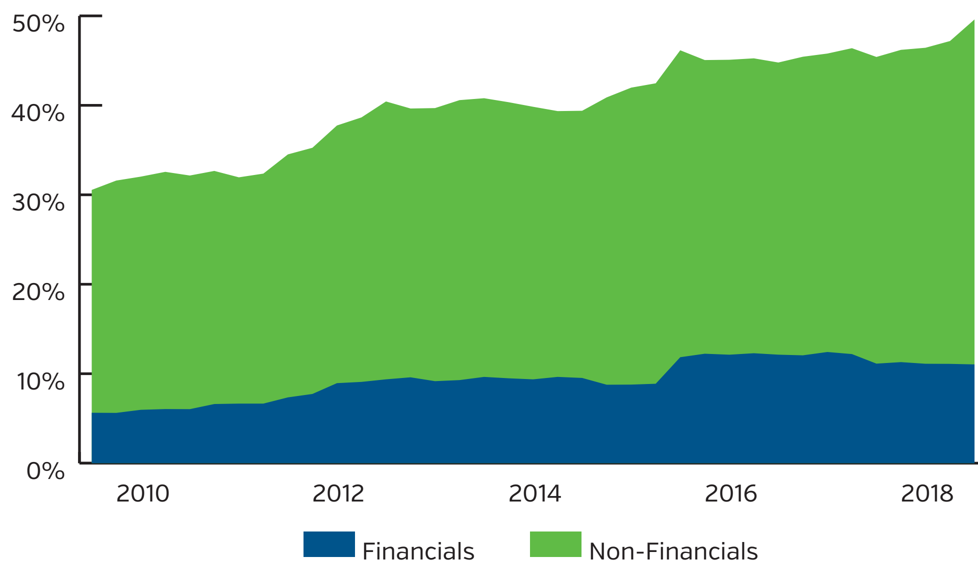
Source: S&P Capital IQ LCD, Goldman Sachs Global Investment Research

IMPACT ON INVESTMENT GRADE

We note that concerns over a potential wave of high yield downgrades among BBB rated issuers will likely continue to mount. As a result of more shareholder-friendly financial policies, despite rising cash flows, the overall investment grade index has a much higher percentage of BBBs than it has in the past with almost 50% compared to 32% in 2010 (Chart 9). In addition, 40% of BBBs are now leveraged greater than 4x debt/EBITDA*, more indicative of BB credit quality than investment grade. In anticipation of the more difficult credit landscape foreshadowed by leveraged markets coupled with tighter spreads, we currently have an up-in-quality bias. We have been investing for our clients in companies with stronger balance sheets and financial flexibility while selling those credits that we believe face longer-term challenges. We are also taking advantage of spreads widening in higher quality names as the market experiences bouts of volatility.

** Earnings before interest, taxes, depreciation and amortization*

Chart 9. BBB Rated Bonds as Percentage of IG Market



Source: Bloomberg, Gloldman Sachs Global Investment Research

KEY TAKEAWAYS

- We are seeing characteristics in both leveraged bonds and loans which could lead to worse recoveries in the next downturn.
- Leveraged borrowers have been the beneficiaries of higher demand from yield-seeking investors who have been increasingly willing to trade easier terms for yield.
- Weaker balance sheets and easier covenants could lead to higher levels of distress than otherwise would have been the case when the next downturn does hit the market.
- While near-term recession and default risks are low, the seeds for potential stress have been sown and are an indication that headwinds are building for the corporate bond market.
- Our current investment strategy for clients in the investment grade corporate sector is focused on three areas: 1) buying higher quality credits 2) selling credits with deteriorating fundamentals and 3) buying bonds of companies whose spreads have widened materially but we are comfortable owning from a credit perspective.

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