A Primer on Loans

Matthew Mimms | 7th October 2020

With interest rates low, interest in credit as a source of income is increasing. This article takes a closer look at one sector of the credit market, Syndicated Loans, and provides some context on Loans characteristics and where opportunity and risks lie for investors.

What is a Syndicated Loan?

A Syndicated Loan is a senior loan that is made to a company whose credit rating is generally below investment grade. Typically, the loan will be sourced from a syndicate of lenders and arranged and structured by a commercial or investment bank (lead arranger). Loans will be used for a variety of purposes including acquisitions and debt restructuring. Syndicated Loans are senior secured, generally pay a floating rate of interest, have a maturity date and can be redeemed early. Syndicated Loans have priority in repayment over other lenders (sit equal to bank loans such as revolving credit facilities) and are protected from the borrower's failure to repay the interest or principal by taking over the security of the assets of the company. Security enhances recovery levels in the event of a borrower's default (senior secured debt holders get paid before other debt, and equity holders). In addition, loans generally have covenants which allow the lender to take action to protect their investment.

What are the characteristics of Syndicated Loans?

We have outlined below some of the key characteristics of Syndicated Loans in the US and Europe…

- Credit Spread – Syndicated Loans will pay a higher level of interest than say a sovereign bond due to the lower credit quality of the company (borrower). This credit spread compensates the investor for the additional risk. The credit spread at any one time will vary depending on market conditions but historically sits in a range between 3% 6% range (i.e. cash – in the form of a Libor rate – plus 3% +). During more challenging financial conditions, the spread will be higher than during more benign economic periods.
- Higher Yield – The credit spread means that Syndicated Loans will pay a higher yield that more conservative fixed income assets and cash. For example, the Yield to Maturity for Syndicated Loans in NZD (as of 30 June 2019) was 6.45%[1].
- Lower Credit Rating – The reason why the yield is higher for Syndicated Loans is because the credit ratings of the borrower's is typically below investment grade (BBB-). The average credit quality of the sector is BB-. One of the reasons that credit ratings are poorer is because Syndicated Loans tend to be made to companies that are more highly leveraged.
- Senior Secured – Syndicated Loans are largely senior secured and represent the most senior debt obligations in the capital structure. In the event of a default, Syndicated Loans will typically have a much higher recovery rate than other lenders and equity holders. For example, between 1990 and 2015, the average recovery rate for leveraged loans where a default occurred was 67.21 (i.e. in the event of a default, borrowers received on average 67c in the dollar back)[2].
- Market Size and Diversity – The Loans market is a large traded market. For example, as at 30/9/19, the index which tracks the market for US denominated Loans had a market size of $1,221 billion USD and consisted of 1,399 issuers[3]. The market is highly diversified across different industries and sectors such as Electronics, Healthcare, Chemicals, Telecommunications, Buildings and Real Estate and Broadcasting and Entertainment. The US loan market provides a larger exposure to private companies over public companies which gives more underlying issuer diversity. In 2018, the European Loan markets was €181 billion in size[3].
- Liquidity and pricing – The US Loans market is a daily traded market where market makers perform the task of pricing and facilitating trades in the secondary market. For the three months ending May 2020, secondary market activity totaled $256bn for US loans[4]. Investors in the loan market will incur a buy/sell

spread that reflects the cost of transacting in loans. The size of the spread will vary depending on market conditions.

- Covenants – like other debt arrangements, the rules under which a borrower must act are governed by Covenants. These will typically stipulate certain financial ratios and activities that the borrower must meet to fulfil the terms of the loan. It could for example require the borrower to maintain certain debt to earnings ratios and restrict the pay-out ratio policy. Covenants protect lenders by prohibiting certain actions by the borrower that could significantly increase risk. From the borrower's perspective, debt restriction can reduce the cost of borrowing. Where a borrower breeches Covenants, it may be an early warning sign that the company concerned is in financial difficulty. The lender can undertake several different actions including demanding penalty payment, increasing the interest rate charged or terminate the loan.
- Libor Floors – Typically, Syndicated Loan spreads are based on the current Libor rate. For example, a Loan might pay interest at Libor plus a spread (say 400bps). With interest rates low, and once again falling, many recent Loans have Libor Floors which is a fixed base rate above which the spread is paid. For example, in Europe, where the Libor rate is in fact currently negative, a Libor floor of 0% might be set above which the interest rate (spread) is established. Remembering that Loans are floating rate securities, this has the effect of protecting the overall interest investors receive should rates fall further (though conversely not benefitting initially at least as rates rise).
- No free lunch – Longer term performance and volatility indicate that Syndicated Loans is an intermediate risk asset class, producing higher yields than traditional fixed income assets but with a lower level of volatility than equities. Whilst the senior secured nature of Loans may help protect the investor from losses in the event of a default, the asset class will experience price volatility during recessionary and market disruptive events (refer below).

Collateralised Loan Obligations (CLOs)

A CLO is a form of securitization which provides exposure to a pool of syndicated loans where payments from multiple loans are pooled together and passed on to different classes of owners in various tranches. Those tranches are rated (by an independent ratings Agency) from AAA through to Equity. Income from the loans is passed through to investors. An investor in a AAA tranche will receive less income than a lower rated tranche holder but has greater protection from defaults and losses (should they occur) than investors further down the tranche structure. As at Q2 2017, the US CLO market stood at $US 420 billion[5]. During the GFC, whilst marked to market value volatility was high, permanent losses from credit defaults was low. For example, and according to a 2015 study by Wells Fargo which examined default rates across CLOs between 1994 and 2013, the cumulative default rate for AAA and AA rated CLOs was 0%. Even in the lower tranches, default rates were low (BBB rated CLOs had a default rate of 2.26%)[6].

Have Syndicated Loans become more or less risky?

Notwithstanding current market conditions, there has been some comment that the Loans market has becoming much riskier over the past few years. One key reason cited is a significant increase in Cov-Lite loans. In a world of very low interest rates and seemingly awash with liquidity, there has been a shift of power away from lenders demanding attractive yields, and to borrowers. This has led to an increase in Cov-Lite loans which lack some of the protective covenants such as maintenance tests which require the borrower to meet certain financial performance standards. Cov-lite facilities are at times viewed as potentially riskier than customary loan facilities because they remove the early warning signs lenders would otherwise receive through traditional covenants; and thus impact the ability of lenders to take steps to mitigate a possible default. In addition, the added flexibility provided to borrowers in terms of their ability to, for example, under certain circumstances, pay dividends, means that lenders have less control over the activities in which borrowers may engage.

As at the end of 2018, 85% of all US leveraged loans were covenant-lite, according to S&P Global Market Intelligence. Whilst the growth in Cov-Lite loans has been perceived as negative, the diversity and liquidity in the Loan market can provide a tool for investors in Loans to mitigate potential risk. Statistically, evidence pointing to greater risks in Cov-Lite loans is mixed. For example, default rates for the US Loan market have been slightly lower on average for Cov-Lite deals vs fully covenanted deals though this is not routinely the case in ever year. An April 2018 research paper from Credit Suisse found that whilst the average recovery rates for defaulted loans with financial covenants since 2009 tend to be higher than those without, ultimate loss rates over time are superior for Cov-Lite loans vs fully covenanted[7].

How have Loans faired during the COVID-19 Pandemic?

As the effects of the COVID-19 Pandemic deteriorated during February and March, and concerns of the impact of economic lockdowns across the world increased, credits spreads widened dramatically (investor globally sought safe haven investments such as Treasuries, USD and sold out of risker assets such as equities and lower rated credit securities). At the end of June 2020, credit spreads on US Leveraged Loans stood at 844 bps up from 471 bps at the end of 2019. Consequently, the market value of loans fell during the March, with the Leveraged Loan Index falling by 13.05% (in NZD terms)[8].

Fears of a liquidity credit crunch were however quickly allayed as Central Banks used every means at the disposal to support markets (including ultra-low cash rates and the US Fed's purchase of investment, and non-investment grade credit via ETFs). In addition. Governments globally embarked on massive fiscal spending measures to support economies (the G-20 has directly spent over 4.5% of GDP with an additional 5% of GDP on loans, equity guarantees). As a consequence, leveraged loans and other credit markets have recovered steadily over the June Quarter (Loan spreads closed the quarter at 647bps, down from 844bps), the index being up 9.4% in NZD terms[8]. This trajectory has continued during Q3 2020.

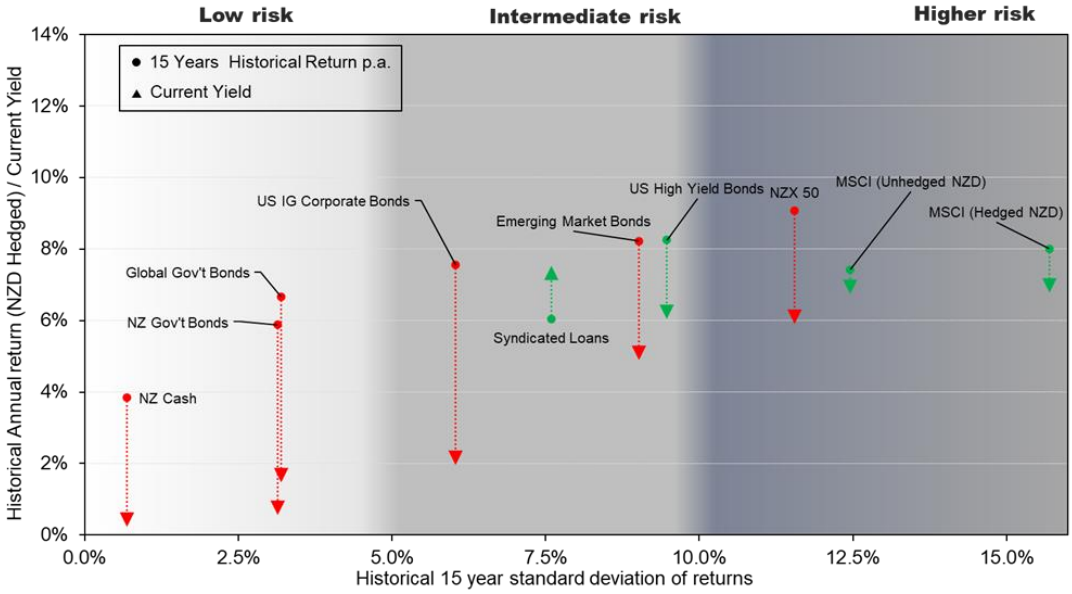
Risks to the global economy remain with The World Bank forecasting the deepest economic contraction since the 2nd world war, not something to be treated lightly given the negative impact on earnings and associated increase in default rates as the number of bankruptcies rise. S&P reported the annual default rate for the loan market at 3.7% at quarter end (June 30), up from 2.02% at the end of the previous quarter. JPM are forecasting year end defaults for Loans of 5%[8].

The outlook over the short to medium terms is dependant on the path of the virus (and its effects on consumer confidence and the action taken by central banks).

In summary, US and European Syndicated Loans experienced price volatility during the early stages of the Pandemic but have recovered more recently in response to supportive monetary and fiscal policy.

How might Syndicated Loans benefit a diversified investment portfolio?

Like other types of credit, Syndicated Loans are an intermediate risk asset class. They typically pay a higher yield that cash and higher credit rated and sovereign debt but with lower volatility than equities. The chart below illustrates the risk and return profile of Syndicated Loans vs other assets classes:



Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley & UBS
Past performance is not a reliable indicator of future performance.
For equities Bentham inverted the forward PE and add 2.5% growth. Forward inflation is 10yr break-even inflation
Investors should vary their estimate of growth to the equity earning yields to compare returns.

As at 31-7-2020

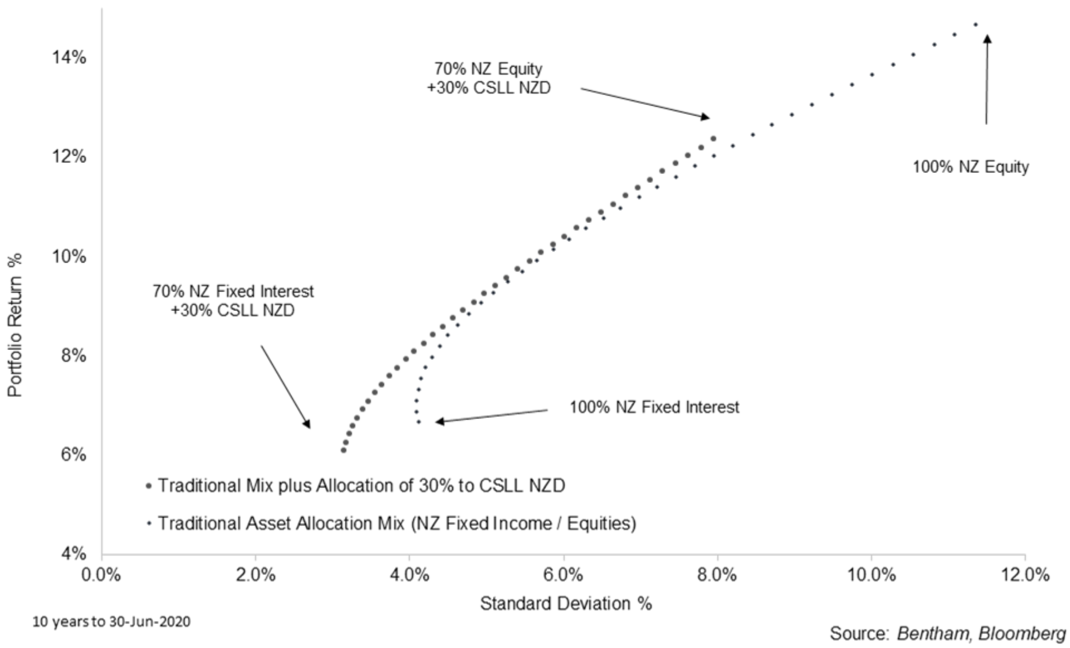
One interesting point to note is that the current yield (as illustrated in the arrows in the chart above) for most assets is much lower than it has historically been. As can be seen, Loans offer a competitive yield when compared to other assets and taking into account their historical risk (volatility).

In addition, Syndicated Loans tend to have a very low, in some cases negative correlation to more traditional fixed income, and a reasonably low correlation to equities. This is highlighted in the following chart:

Asset Class Correlation	Leveraged Loans Index (Hedged to NZD)
Leveraged Loans Index (Hedged to NZD)	1.00
Global Government Bonds (Hedged to NZD)	-0.29
NZ Government Bonds	-0.20
Global Aggregate Bond Index (NZD Hedged	-0.19
World Equities (Unhedged)	0.43
New Zealand Equities	0.30

Monthly data since Oct 2013 as at Sep 2019. Overseas returns (except World Equities) are fully hedged into New Zealand dollars. Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley & UBS. Past performance is no indication of future performance.

At a portfolio level, when Syndicated Loans are added to a traditional portfolio of bonds and equities (in the example here, a combination of NZ bonds and equities), the effect is to improve the risk adjusted returns of the portfolio and shift the efficient frontier to the left (i.e. a better return for a lower level of risk).



Please note CSLL NZD refers to the Credit Suisse Leverage Loan Index hedged to NZD.

In summary, incorporated Syndicated Loans into a portfolio of equities and bonds can improve the risk adjusted returns of that portfolio.

Investing in Loans

Unsurprisingly, syndicated loans are an institutional class asset that is typically accessible only by large institutional investors such as fund managers, asset owners and insurance companies. Investing successfully in loans requires a strong credit skillset and requires in-depth research and analysis at both a sector/industry and individual loan/security level.

Whilst direct access is not possible for retail investors, they may be able to gain exposure to loans as part of a diversified bond strategy, or a sector-specific syndicated loan fund offered by a fund manager specializing in credit and fixed income.

Summary and Conclusion

In summary:

- Syndicated Loans are a senior secured and floating rate fixed income asset class that provide for a higher yield than traditional fixed income assets but with a lower level of volatility than equities. Loans are an intermediate risk asset class.
- The US and European Loan markets are typically sub-investment grade; being senior and secured helps provide protection to lenders (investors) in the event of a company (loan) default.
- The US and European markets are liquid and marked to market with most securities rated by an independent ratings company.
- Loans typically have a very low to negative correlation with some other fixed income assets such as government bonds with the ability to bring diversification benefits to multi-asset portfolios.

Sources
[1]Bentham Asset Management, Bloomberg, Barclays Capital and Morgan Stanley. As at 30/06/20.
[2]Moody's Investors Services, JP Morgan, S&P LCD, Markit.
[3]Bentham Asset Management. Refers to the Credit Suisse Leverage Loan Index in the US, $1221B; and S & P Global Market Intelligence in respect of the European market.

[4]The Loans Syndications and Trading Association
[5]SIFMA, Bentham Asset Management
[6]www.lsta.org/news-and-resources/clos-the-big-long
[7]Credit Suisse, CS Credit Strategy Daily Comment, 13 March 2018, & 27April 2018.
[8]Bentham Asset Management

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