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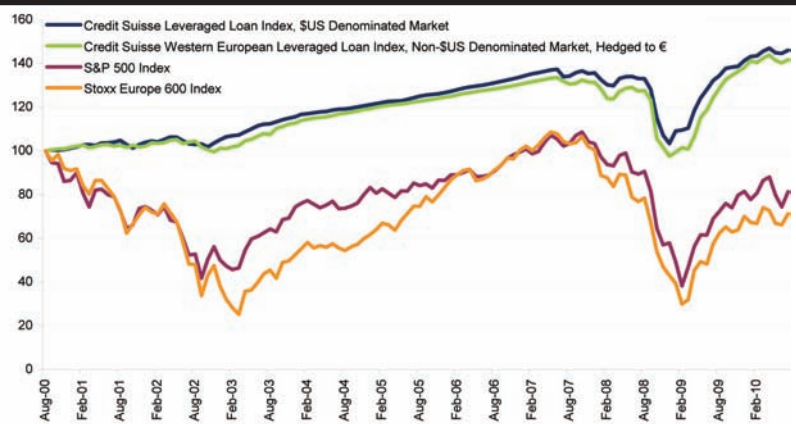
Global senior secured credit: An overlooked asset class

Andrew Godson, managing director at Babson Capital Europe, argues that global senior secured credit looks set to present attractive investment opportunities for the foreseeable future

With many portfolio allocations displaying similar characteristics, such as significant yield compression, increasing correlation and relatively high volatility, asset allocators are becoming more focused on seeking higher yielding asset classes which will diversify their portfolio and raise returns without adding too much volatility.

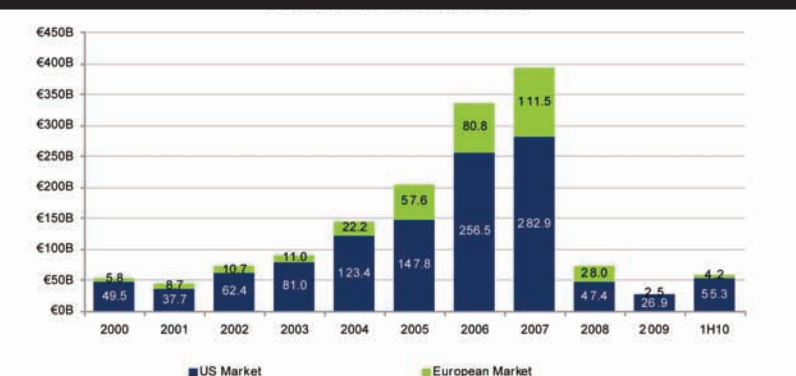
Many UK and European fixed income and alternative investment professionals increasingly view senior secured loans as an important asset class for allocation for this reason. With a lengthy history of attractive returns, relatively low volatility and robust recovery statistics in downside scenarios, it is perhaps surprising that the trend has not been quicker to arrive (see Fig 1).

Fig 1: 10-Year Volatility of Loans Vs. Equities (rebased to 100 as at 31-Aug-00)



Source: Credit Suisse, Bloomberg, as at 30-Jul-10

Fig 2: Institutional Loan Issuance



Source: S&P LCD Leveraged Loan Review - US/Europe 1H10

The exponential growth of the last decade

Historically, senior secured loan issuance, which in both Europe and the US grew exponentially between 2000 and 2007 (see Fig 2), was absorbed through increasing demand from banks and most markedly from structured vehicles like CLOs and hedge funds utilising cheap, bank-driven leverage. As a result of this relatively specialist syndicate of investors, surprisingly few pensions and insurers directly allocated to loans during the last decade .

Floating rate coupons and high recovery rates make for an attractive asset class

Although generically rated below investment grade, with security over the operating assets of the issuing company, attractive floating rate coupons and statistically high recovery rates even in defaulted scenarios, it is straightforward to see why they worked well for banks and leveraged funds in the past.

These characteristics are once again proving highly attractive to a growing number of pension,

insurance, sovereign wealth and private wealth managers on a global scale who are gradually replacing the absent demand from banks and leveraged vehicles.

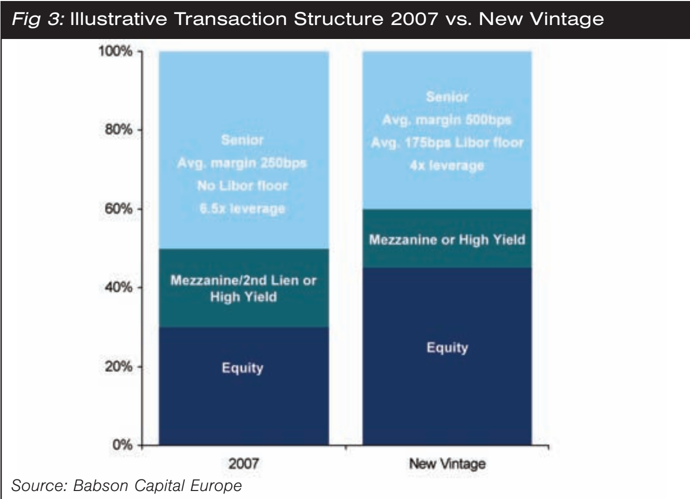
Ongoing technical factors = generous yields

As a result of the rapid fall-off in investment in the senior secured loan market from their more traditional investors, driven by the contraction in bank leverage during 2008/2009, an ongoing supply-demand imbalance has ensured that returns have not compressed as rapidly as they have for other asset classes. Senior secured loans issued between 2005 and 2007 continue to trade at significant discounts to par with yields in the Libor + 500-750 bps region for many issuers that have continued to perform robustly.

At the same time, both LBOs, the key driver of loan issuance in Europe, and M&A deals, which have historically driven around 50% of US issuance, are progressively seeing more transactions brought to the market. The attractive risk profile of these new loans combined with generous yields of an average Libor (frequently floored) + 500bps are evidence of the technical aspects of liquidity which keep yields generous (see Fig 3).

The demand for new or replacement financing from these two key markets, through secured, sub-investment grade loans and bonds, looks set to rise in the coming years, with well publicised refinancing needs adding to a growing pipeline of issuance on both sides of the Atlantic. This augurs well for the maintenance of attractive yields on senior secured loans and bonds, and their establishment as an important allocation area for pension funds seeking longer term exposure to the asset class.

Fig 3: Illustrative Transaction Structure 2007 vs. New Vintage



Source: Babson Capital Europe

The rise of a hybrid – senior secured bonds

Much of the recent increase in senior secured bond issuance has proved an attractive hybrid of the senior secured loan and unsecured bond markets. While investors have understandably valued the seniority and security inherent in the senior secured loan market, not a feature of the unsecured high yield market (evidenced in historical recovery statistics), the high yield market has consistently outperformed the loan market in the last two years, often trading at similar or tighter yields despite the unsecured nature of issuance, a relationship which is unlikely to persist in the long term.

Much of this outperformance can be explained by the fact that the high yield bond market has been an established core allocation for global pensions and insurers over the last decade, as well as enjoying a strong following in the retail fund market. As a result, the liquidity supporting the high yield bond market has proved more resilient than the bank- and leverage-driven liquidity in the loan market, and these investors have also been faster to mobilise capital to take advantage of the opportunities presented.

As a way to tap into bond market liquidity, while also attracting traditional senior secured loan investors, issuers are increasingly approaching the market with senior secured bonds. The terms of these issues are by no means uniform, particularly in terms of the quality of security being offered, but for some of the new senior secured bonds, the terms combine several of the most attractive features of the senior secured loan and the unsecured high yield bond markets (see Fig 4)

This is particularly important for investors who favour the senior secured loan market but require either the greater liquidity or UCITS compatibility inherent in the settlement conventions of the bond market, who do not view floating rate as valuable in the short term or who prefer the high running yield. The senior secured bond market is a growing proportion of global issuance (see Fig 5), and has seen increasingly high quality issuers offering strong security packages.

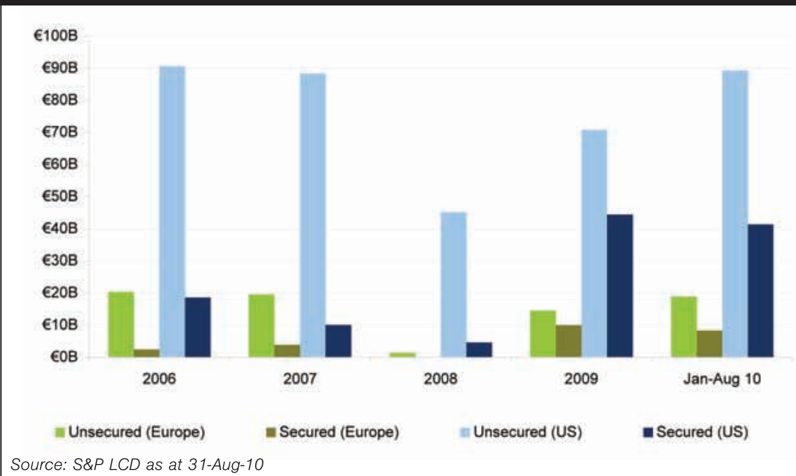
As such senior secured bonds, either as part of senior secured loan portfolios, high yield bond portfolios or as a standalone allocation, are likely to be one of the major growth areas in the sub-investment grade

Fig 4

Criteria	Senior Secured Loans	Senior Secured Bonds	Unsecured High Yield Bonds
Ranking	Senior	Senior	Structurally subordinated
Covenants	Strong covenant package allows for early warning of underperformance	Limited covenants	Limited covenants
Security	Secured by collateral	Secured by collateral	Unsecured, issued at holding company
Current Yield	Typically €+500-750bps Floating rate, discount to par part of yield	7-9% Fixed rate coupon, high running yield	9-12% Fixed rate coupon, high running yield
Settlement	T+10 (EU) / T+7 (US)	T+3	T+3
Issuers	LBO driven in Europe. 50/50 LBO/Corporate in US.	LBO driven in Europe. 50/50 LBO/Corporate in US.	Driven by Corporate market, significant crossover with loan market.
Recovery in Case of Default	EU LTM Jun-10 - 53.52% US LTM Jun-10 - 63.59%		EU LTM Jun-10 - 39.04% US LTM Jun-10 - 50.15%

Sources: Babson Capital Europe; Recovery Rates - Credit Suisse, 2010 Leveraged Finance Mid-Year Outlook and Review 30-Jul-10. Because of the private nature of the leveraged loan asset class, the universe studied in the analysis is limited to information on institutional leveraged loan tranches that could be sourced in the public domain

Fig 5: Secured vs. Unsecured High Yield Issuance (2006 to Aug-10)



Source: S&P LCD as at 31-Aug-10

credit market in the coming years.

Diversify with global senior secured loan/bond allocations

There are some key areas to consider when allocating to both senior secured loans and bonds. While the high level characteristics of these markets are attractive, the arbiter of long term value for individual issues lies in idiosyncratic details pertaining to security, underlying credit quality and other fundamental factors.

Ultimately, these sub-investment bonds and loans will lend themselves to intensive bottom-up credit analysis. Capitalising on the value inherent in these markets requires a considerable depth of analytical resource to differentiate value in the secondary and primary markets. For this reason, active management versus an index approach should over the longer term be rewarded particularly in terms of lower default rates and higher recoveries.

Given the size of the respective markets it is possible to develop diversified, senior secured loan portfolios entirely based on European or US issuers. Managers who have the depth of analytical resources can offer products that bridge the European and US market. Many investors are seeing the value in a more global outlook, with the increased choice, diversification and relative value presented by incorporating these markets together. While the senior secured bond market is growing rapidly in both Europe and the US, in the near term, the limited universe means building a fully diversified portfolio will require access to both the European and US secondary and primary markets.

Looking forward

Sub-investment grade credit, because of a large pipeline of new issuance and refinancing building up in Europe and the US, looks set to present attractively priced investment opportunities for the foreseeable future. For investors looking to access the higher yields available in this market, while at the same time mitigating downside risk and volatility, the security inherent in the well established international loan markets and the burgeoning senior secured bond markets is likely to be an attractive area for new or increased allocation. For investors focused on inflationary concerns, the floating rate available in the loan market is proving attractive. And for investors who are more focused on high yield bonds and who have enjoyed the high running yields, liquidity and strong performance in their portfolios in recent times, there is now an opportunity to access similar yields with the risk and volatility mitigating addition of security through allocating to the senior secured bond market.

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Global loans: why now?

Peter Davy asks why now could be the perfect time for pension funds to consider loans as part of their investment portfolio

For pension funds considering allocations to loans, two things should firstly be put into context: the big falls during the financial crisis, and the recovery seen since.

The first is, perhaps, the more obvious. It is no surprise that loans along with most other asset classes suffered in the credit crisis. The forced selling driven by the collapse of Lehman Brothers saw average prices of European loans fall by over 35% during 2008, according to the Credit Suisse Western European Leveraged Loan Index.

As Otis Casey, loan market analyst at financial information firm Markit, explains: "The fall in the markets was a shock by any measure, but particularly unexpected in loans, given the low correlation and volatility relative to other asset classes.

"Indeed, a big part of the reason hedge funds and CLOs felt safe to use so much leverage was down to the underlying stability. Seeing equities, bonds or other asset classes fall as they did was not pleasant but was at least understandable in a historical context. For loans it was fairly unprecedented," says Casey.

Of course, indices don't tell the whole story. Consider the recovery rate, for example. Indices don't show that but rather the loan price post default. Hymans Robertson's head of manager research Stephen Birch explains, it's an imperfect proxy and has tended to exaggerate the risk. Look instead at what most of the institutional loan managers actually experienced in their portfolios and it's a different story: yes, defaults rose and recovery rates dropped, but not to the extent the indices suggested.

"The risk that you face is a function of the default risk but the recovery rate as well," he points out. "Ultimately it's the risk of loss you're concerned about, so default in itself doesn't necessarily matter if you get your money back."

And that the slump was liquidity based rather than credit-driven is confirmed by what's happened since, with prices shooting up again in 2009. Take the US. Loan prices fell by over 30% in 2008. However, they have since made that back and more, returning 45% last year. The conclusion many rightly draw: loan markets overreacted in 2008, with prices significantly overstating the risk of default.

From opportunistic to strategic

While that swift recovery might seem to prove the market's resilience it does little to reassure investors that volatility is a thing of the past. It also means that those who didn't invest may feel they missed the boat. While much of the 'dislocation' premium has undoubtedly eroded, returns in the Libor +500-750 range, combined with long-term expected recovery rates above 70%, mean loans remain attractive.

One company, MN Services has seen increased interest in loans among its institutional clients. Markus Schaen, senior fund manager at MN Services says: "For pension funds, bank loans sit very well among the high yielding asset classes because from a risk/reward perspective they are seen as an interesting addition and there is obviously the floating rate aspect too; but there is also the security factor i.e. they are senior secured. They should be less volatile than the high yield products but also give you a very good spread.

"We introduced them to our clients about 12-18 months ago and, while they may not be allocating as much to loans as they are to high yield, most of them have taken them up and they like what they get from this asset class. They like the predictability; the security; and the fact that the loan documentation is, in many cases, better than for normal investment rate bonds. So you get a good combination of risk and reward."

Going forward, Schaen expects to see more pension funds getting involved. "It took a while for pension funds to get used to the product and there is still some education to be done. Saying that, it isn't too complicated a product to be in – it's actually much more transparent and easy to understand than some others – it's simply that people aren't that familiar with it mainly because, in the past, you had to be a large fund to participate in this market but that is changing too."

Whilst improving in terms of familiarity amongst investors, the risks that were shown in 2008 may have discouraged some. After all, high yield bonds have seen better returns than loans lately but under-

standing the security differences between loans and bonds will qualify return characteristics. Sticking to familiar asset classes may make sense, understanding these differences should form a more rounded argument for allocations to both bonds and loans on a strategic rather than opportunistic basis.

Consider SEB Pension in Denmark. Its exposure to loans prior to the crisis was through CLOs and structured vehicles, with the fall in loan prices, it saw the opportunity in unleveraged exposure to US and European senior secured loans, allocating 5% of its assets to them. As portfolio manager Mads Skaaning Jensen explains, that was initially seen as a medium-term bet. However the speed of recovery surprised it. "It caught up much quicker than we thought so ended up being a much shorter term move," he says. SEB has now scaled back its exposure, but maintains a very meaningful allocation.

A persistent case

The tactical case for loans remains. Ongoing supply-demand imbalances ensure many senior secured loans issued between 2005 and 2007 still trade at significant discounts to par, yielding between Libor +500-750 bps. At the same time, LBOs and M&A deals are progressively seeing more transactions brought to the market. The risk profile of primary loans combined with yields of an average Libor (frequently floored) +500bps are evidence of the technical aspects of liquidity.

Even if you think further price increases are unlikely, loans are floating rate investments, so there's an attractive opportunity: "If you are of the view that rates at any point in the next couple of years are going to have a significant run, then a floating rate market where there is very little value currently applied to Libor is pretty attractive as an inflation hedge," points out Andrew Godson, managing director at Babson Capital Europe.

Some argue the pricing depends on which part of the capital structure you look at. Mercer, for instance, is encouraging clients to consider mezzanine debt. While senior loans may have corrected toward historical levels, the correction back to normal rates for mezzanine has been slower and the risk profile of these loans has shifted significantly. Lower levels of leverage mean that equity positions of up to 50% are now common, providing greater security for the loan. In fact, in many cases the banks in the past would have provided senior loans to cover the part the mezzanine debt now takes. Clearly this means the senior loan, sitting above the mezzanine, has also improved in terms of security in the primary market.

Sanjay Mistry, principal at Mercer, argues: "Investors are almost getting the level of security that used to be associated with senior loans for mezzanine investment returns."

More importantly, the case for loans remains much the same : the security with senior secured recovery rates back up to long term averages of near 70%; the floating rates, which can see them play an interesting role in LDI structures; and the potential for diversified credit exposure still offering a decent spread for the risk. Loans and high yield bonds have returned similar amounts, but whilst the bond isn't secured the loan is, consequently the Sharpe ratio for senior secured loans is significantly higher than that for high yield bonds.

Of course, the market is relatively illiquid but that's part of the argument for pension funds' involvement: "Pensions have this wonderful long-term investment horizon that they should be rewarded for, and loans are one of the few asset classes that give you that premium for holding an illiquid asset," says Redmond. "For pension funds, they fit."

There remain some provisos. The first is that while few expect a repeat of 2008 and 2009, many think broader market volatility will remain Furthermore there is the concern over the approaching "maturity wall" – where many of the loans written at the height of the boom come due.

However, given what's been said and those long-term horizons, pension funds should be able to ride out price volatility provided recovery rates remain reasonable. Similarly the maturity wall, will provide oppor-tunities for pension funds, as there will be a lot of viable companies that banks no longer want or can support because of new capital requirements.

As Nicholas Voisey, a director at the Loan Market Association says, it is not a new problem, and some of the refinancing has already been done or is underway. "The finance directors and management of these companies and the lenders aren't going to start thinking about this in 2012 or 2013, they are thinking about it now."

For those pension funds that haven't already considered loans, it might be time they did the same.

WRITTEN BY PETER DAVY,
A FREELANCE JOURNALIST

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