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Senior Loans: Positioning Portfolios for a Maturing Cycle

Senior floating-rate loans—also known as bank loans or leveraged loans—have been a magnet for capital for several years now, as investors concerned about the potential for rising interest rates have been drawn to the investments' unique combination of relatively high yield potential and low duration. Risks to the asset class are gathering, however, as unflagging demand for senior loans has led to a decay in underwriting standards, the impact of which is unlikely to be fully appreciated until the credit cycle turns. Though the appeal of a floating coupon in a rising-rate environment is likely to persist, disciplined active management will be needed to navigate what's certain to be a more challenging market environment.

Executive Summary

- Driven by demand from institutional and retail investors in anticipation of rising rates along with robust collateralized loan obligation (CLO) issuance, the senior floating-rate loan market has more than doubled in size since 2012 and now rivals the high yield bond market.
- The attributes of senior loans—such as low duration, seniority in the capital structure and covenant protections—historically have resulted in higher recovery rates than high yield bonds and higher long-term risk-adjusted returns than other major fixed income asset classes.
- Strong demand for senior loans has been met by a decline in underwriting standards among loan originators eager to meet it, creating new risks for investors. Current underwriting behavior suggests that non-investment grade debt in general may experience greater defaults and lower recoveries during the next downturn.
- As the credit cycle matures, investors likely will be better served by a defensive positioning that recognizes the potential for lower recoveries and is based on a fundamental assessment of and the differentiating risks presented by covenant protection, leverage levels and collateral.

The senior loan market has seen explosive growth over the last several years. Having more than doubled in size from approximately $517 billion in 2011 to over $1.1 trillion today, the amount of loans outstanding is now nearly on par with that of the high yield bond market, which has grown by less than half over the same period. There also is an active secondary market for bank loans, with more than $2 billion of loans on average traded daily by a wide range of institutional investors. As a result of their popularity, loans have become an increasingly significant part of the capital structure for non-investment grade companies. They've also become a near-mandatory exposure for many fixed income investors, who generally have been well served by such an allocation. Year-to-date through September 30, 2018, for example, loans (as represented by the S&P/LSTA Leveraged Loan Index) have been resilient in the face of renewed financial market volatility and have outperformed other major fixed income asset classes by a fair margin.

Now does not appear to be the time for an aggressive approach to senior loan portfolios, however. As we discuss in this paper, changes in loan market dynamics combined with an aging credit cycle suggest the margin of error for investors is only getting smaller. To avoid those loans most likely to deteriorate or default once financial conditions grow more challenging, a higher degree of investment due diligence is necessary than was the case in recent years.

We believe active portfolio management is necessary to traverse the shifting market and mitigate the potential downside volatility that more benchmark-like strategies may experience fully. While a disciplined active approach to security selection should help avoid loans exhibiting some of the more aggressive underwriting characteristics we are seeing in the market, some loan managers—passive strategies in particular—are unable to make these distinctions. Such managers, for example, are generally indifferent to covenant protections and leverage levels in their portfolio construction models, instead relying primarily on loan ratings and industry diversification to manage risk. Collateralization is another underappreciated differentiator among senior loans; while all loans are secured by the borrower's assets, the resilience of this collateral can vary and cannot be assessed without a commitment to bottom-up fundamental research.

At Neuberger Berman we draw on a large pool of research and investment professionals to make our portfolio decisions, resulting in an asset selection expertise that we believe gives our clients an advantage. While we recognize that our conservative approach to senior loan management may underperform in a beta-driven, broad-based market rally, our portfolios are positioned to excel during prolonged selloffs and lengthy, deep periods of risk reduction, and provide attractive risk-adjusted returns through a cycle. We believe that as this particular cycle matures and ultimately turns over, investors will be rewarded for actively managing risks and that a focus on higher-quality, more liquid loans should result in much better risk-adjusted performance in a selloff.

Senior Loan Demand Remains Strong

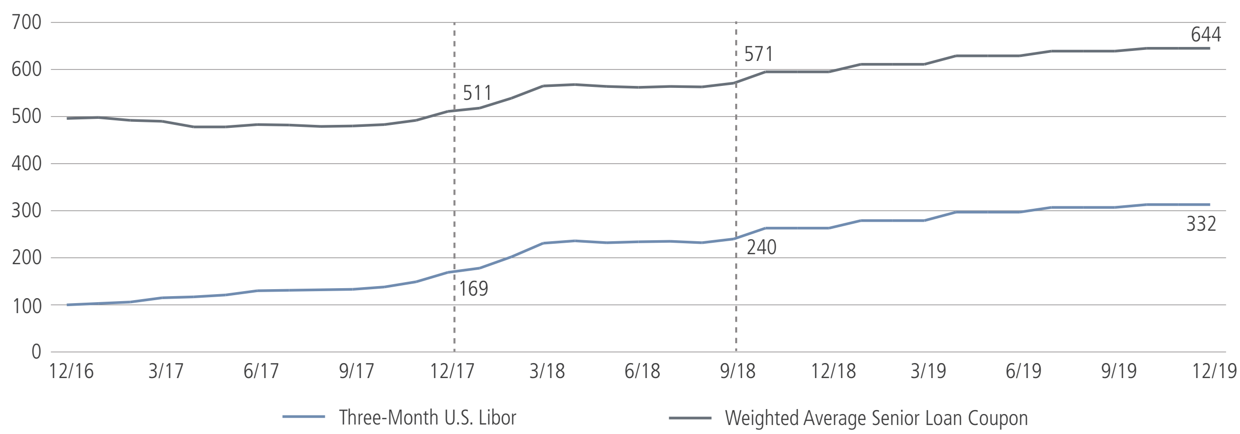
Senior floating-rate loans are privately negotiated lending agreements between a bank (typically on behalf of a consortium of large creditors) and a corporate borrower. Though typically issued with maturities in excess of five years, senior loans usually have coupons that reset every 30, 90 or 180 days based on the prevailing Libor rate, resulting in minimal duration and thus minimal sensitivity to changes in interest rates. And while loans carry not-insubstantial credit risk—the average rating of the U.S. senior loan index is B+—they generally are considered to be more defensive investments than similarly rated high yield bonds. Their senior status in the borrower's capital structure and collateralization mean holders of this paper are higher in priority in the event of default, which historically has resulted in higher recovery rates than high yield bonds. In terms of performance, bank loans have delivered lower volatility and higher long-term risk-adjusted returns (as measured by Sharpe ratios) than other major asset classes.

While senior loans hold obvious appeal for investors in a variety of market environments, the recent spike in demand for these securities has been driven primarily by two forces:

- **Rising interest rates.** After years of zero interest rate policy in the U.S. following the financial crisis, a stabilizing economy alerted investors—both institutional and retail—to the need to prepare their portfolios for central bank policy normalization and the rising interest rates likely to result. The poor performance of fixed income assets during the "taper tantrum" of 2013—in which the 10-year U.S. Treasury yield spiked about 200 basis points over the course of only seven months after the Fed raised the possibility it would slowly reduce its monthly asset purchases at some point in the near future—seemed to help convince those investors who may have been on the fence. Although a durable leg higher in interest rates was slow to emerge, the floating-rate nature of bank loans has enabled investors to benefit from steady increases in Libor since the Fed began raising its benchmark rate in 2016, as shown in Figure 1.
- **Increased CLO formation.** Not coincidentally, the market for CLOs has seen significant growth alongside that for senior loans, nearly doubling from $300 billion in 2012 to about $570 billion today. Too often confused with some of the other acronymous—but much more exotic—products that helped lay the groundwork for the financial crisis, CLOs simply are a securitized pool of senior secured bank loans made to non-investment grade corporate issuers. CLOs are divided into tranches of seniority, typically from AAA to B with an unrated subordinated equity tranche at the bottom of the capital structure.

FIGURE 1. LOAN COUPONS HAVE INCREASED STEADILY WITH LIBOR SINCE FED FUNDS HIKES BEGAN

Basis Points



Source: LCD, Bloomberg, JPMorgan. As of September 30, 2018; projections to December 31, 2019.

Meanwhile, the surge in loan demand has reshaped the character of the high yield bond market, as would-be public debt issuers in many cases have instead turned to banks for their financing needs. This has been especially evident in 2018; year-to-date through the end of September, net issuance of senior loans (which excludes refinancings) stands at nearly $240 billion compared to only $60 billion in high yield bonds.

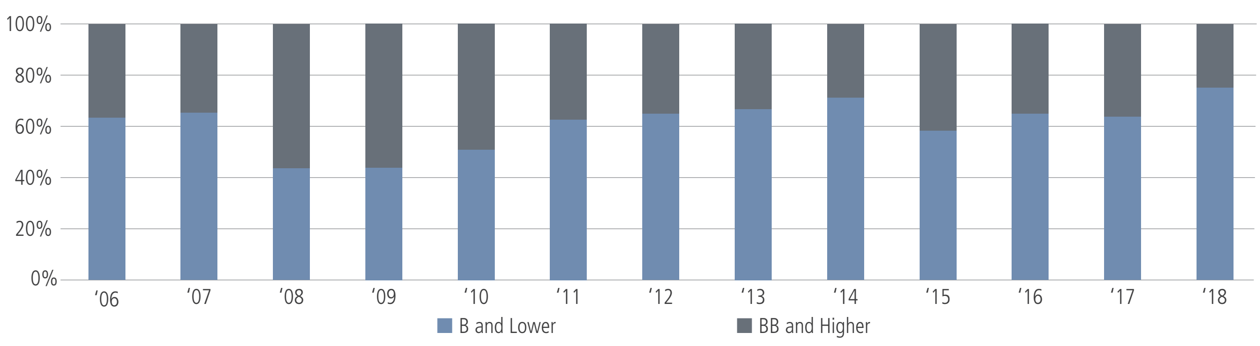
Slipping Underwriting Discipline Is Creating New Risks

While it may seem like senior floating-rate loans are a no-brainer in a rising-interest rate environment, there are signs that the market may prove a victim of its own success as the business cycle matures. The ongoing strong demand for these securities not surprisingly has been met by a decline in underwriting standards among loan originators eager to meet it, creating new risks for investors. As we discuss below, current underwriting behavior suggests that non-investment grade debt in general—both loans and high yield bonds—may experience greater defaults and lower recoveries during the next economic slowdown. We'd highlight three trends in loan issuance to support this view:

- **Increase in lower-rated issuance.** Not surprisingly, default rates grow exponentially at progressively lower ratings. Moody's Investors Service notes that a record 43% of first-time issuers in the first half of 2018 were rated B3[1], which typically is the lowest rating acceptable to investors. Meanwhile, 64% of the U.S. speculative grade population has a corporate family rating of B2 or lower, up from 47% in 2006, while the percentage of new loans rated B2 or lower reached an all-time high around 75%, as shown in Figure 2.
- **Smaller—or nonexistent—debt cushions.** The increased emphasis on loans for corporate financing has resulted in more top-heavy capital structures for borrowers, leaving fewer subordinated lenders to absorb losses before they hit senior secured debt holders. Since the financial crisis the share of debt that is subordinated to first-lien term loans—i.e., the debt cushion—on outstanding covenant-lite senior loans has fallen from 35% to around 22%. Moreover, as shown in Figure 3 loans today also are more likely to be structured as first-lien-only transactions, meaning that loans are the only form of debt financing in the issuer's capital structure.
- **Weaker loan documentation.** The typical loan credit agreement has become less restrictive for issuers, thus presenting greater risk to lenders. Influenced by the growth in M&A activity and leveraged buyouts, the definition of EBITDA within many credit agreements—which impacts much of the remaining protections in the agreement—now includes a meaningful amount of adjustments in favor of the issuer. Credit agreements in general have gotten more aggressive, allowing the issuer such leeway as asset transfers, greater incremental secured-debt incurrence and an increase in the retention of asset-sale proceeds. Such weakening covenant protections have the potential to dilute the position of first-lien loans at the top of the capital structure.

FIGURE 2. MORE AGGRESSIVE LOAN ISSUANCE IN THE U.S. CAN BE SEEN IN LOWER RATINGS…

Percentage of Total New-Issue Loan Volume by Rating

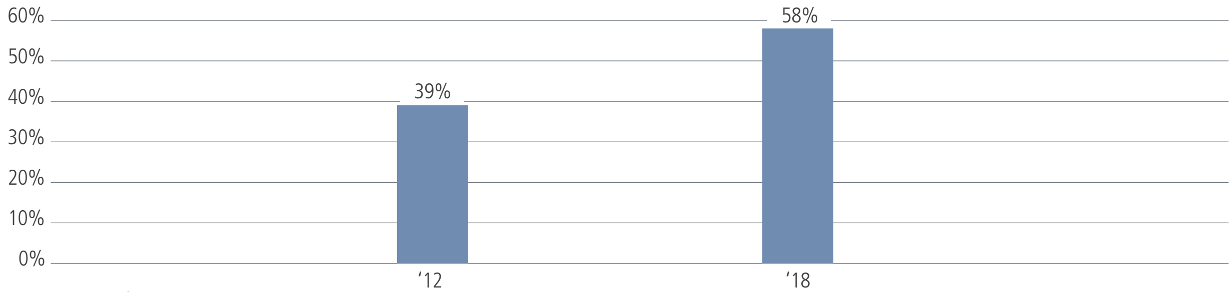


Source: LCD. As of September 30, 2018. Note that a Moody's rating of B2 is equivalent to B rating from Standard & Poor's.

[1] Note that a Moody's rating of B3 translates to a B- rating from Standard & Poor's, while B2 is equivalent to B.

FIGURE 3. …AND MORE LOAN-HEAVY CAPITAL STRUCTURES

Percentage of Issuers with Loan-Only Debt Capital Structures



Source: LCD. As of September 30, 2018.

We believe the conditions described above are indicative of late-cycle loan issuance. While there initially may be fewer defaults in the coming economic slowdown than there were before the shock of the financial crisis (when financial maintenance covenants were still common), these underwriting tendencies are creating credit risks that could lead to an extended and meaningful default cycle—while also making borrowers that become distressed more susceptible to equity-friendly actions—once the current economic expansion ends. They also are creating opportunities for active managers able to discriminate among loans and sectors as they position their portfolios for the downturn.

Conclusion

Senior floating-rate loans have exploded in popularity in recent years, and for good reason; senior loans historically have offered attractive exposure to the non-investment grade fixed income, and we believe these securities should be a strategic allocation in most portfolios. Despite the many attributes of this market, however, investors also must be cognizant of its risks, especially those that have grown in recent years as loan underwriting standards have loosened. To this end, we believe active managers best position investors to withstand the more nuanced market conditions likely to emerge when the credit cycle ends.

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