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Living in a Mostly Loan-Only World

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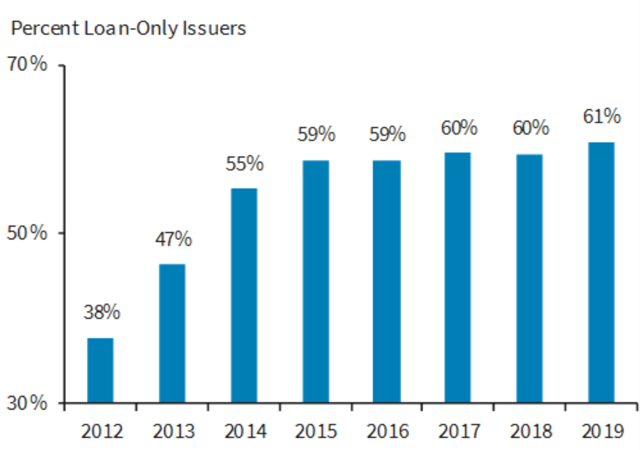
Investors have, understandably, become increasingly concerned about the bifurcation of issuers in the bond and loan markets, making it more difficult to evaluate the universe of credits (especially for private issuers). As we have previously outlined, the growth of loan-only capital structures is one of the many factors that should be a headwind to recoveries, with our expectation for a reduction of up to 10pts (from roughly $70 to $60) through the next cycle for loans (*Downside to Recoveries after a Long Recovery*). Data from Fitch show that loan-only capital structures have historical recovery rates $10 below capital structures with bonds and loans, although most of the sample set is from a period when loan-only was less prevalent ("U.S. Leveraged Loan Default Insight", Fitch, January 2018).

Loan-only issuers continue to make up the majority of the market on an issuer basis and now represent 61% of the index (Figure 1). On a par basis, the relationship is skewed towards dual issuers, as the average size of dual issuer loans is significantly larger. This trend is also evident, though slightly less pronounced, when we exclude issuers with second lien loans, with 55% of 1st lien-only issuers not having bonds outstanding. Per S&P LCD, 34% of first-lien loans issued this year have no debt cushion beneath them. That rate is a record high and up from 29% in 2018. Given the strong relationship between the size of debt cushion and loan recovery, we expect the growth of market with no debt cushion to pressure recoveries).

Besides potentially lower recoveries, there are other reasons that loan-only deals are likely to trade at a discount to loans from dual bond and loan issuers, and we must consider and control for those before we can determine if loan-only issuers are rich or cheap. Investors have placed a preference on liquidity this year (see *Loan Liquidity Premium Persists*), and new issue loans with a debt cushion have been roughly twice the size of new deals with no debt cushion in 2019 (Figure 2). Additionally, the opportunity to attract crossover investors is diminished for many of these loan-only deals, given their smaller size and much higher rate of being from private issuers.

FIGURE 1

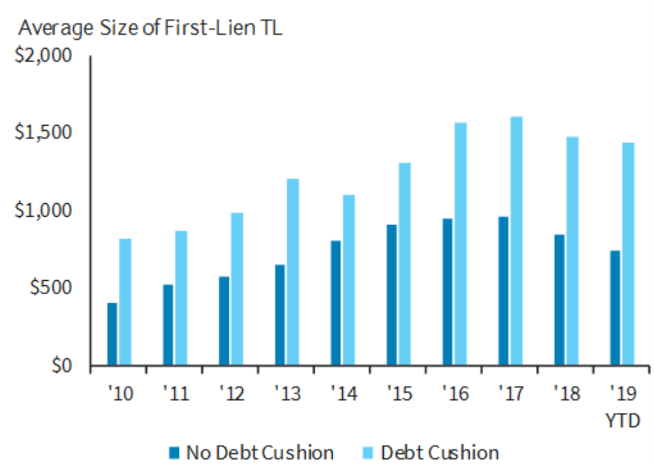
Loan-Only Issuers Make Up a Majority of the Loan Market



Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 2

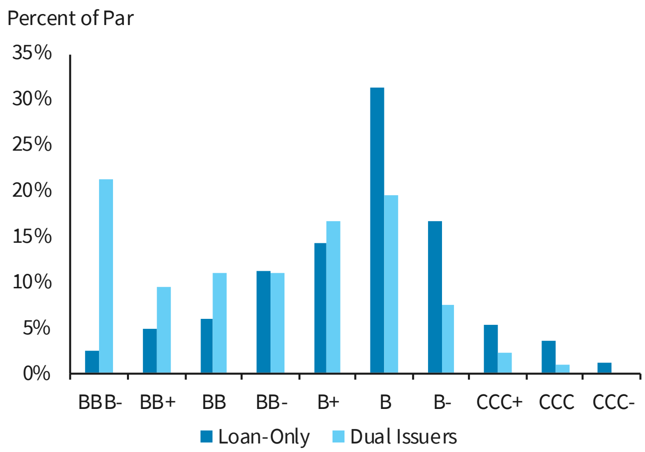
Loans with Debt Cushion Are Double the Size of Loans without a Debt Cushion



Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 3

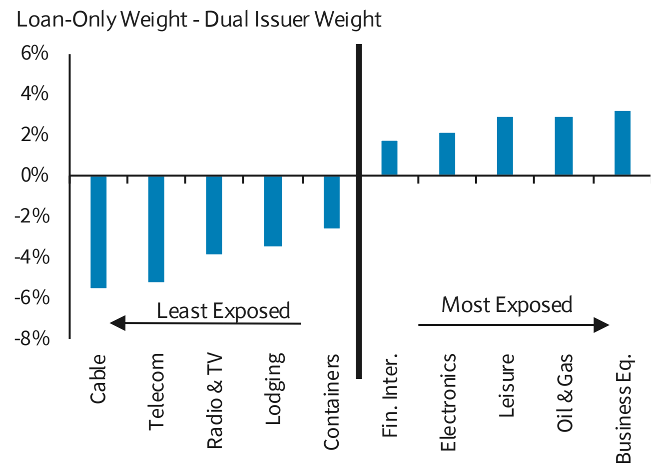
Loan-Only Issuers Tend to Be Lower Rated than Dual-Issuers…



Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 4

…and Have Different Sector Weightings



Source: S&P LCD, Bloomberg Barclays Indices

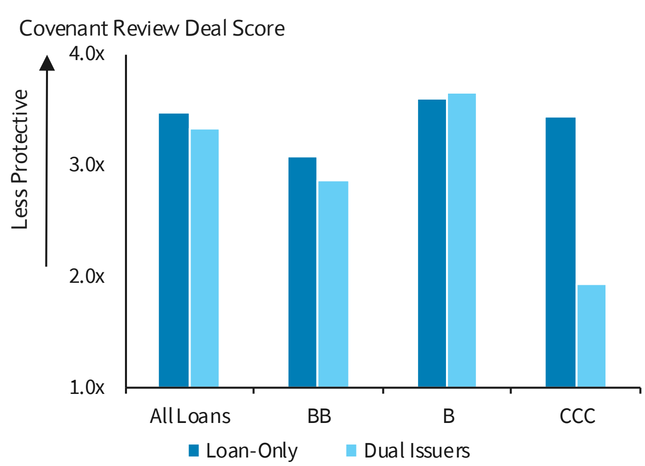
Perhaps the biggest reason that a substantial discount exists in the loan-only universe is that it is generally lower rated than that of dual issuers (Figure 3). Over 60% of par of the loan-only cohort is rated single B, well above the 45% level for dual issuers. Nearly one-fourth of the loan-only market is rated B flat or B-, versus just 14% for issuers with bonds and loans, a segment that will continue to have increased focus, given the potential implications for CLOs if a wave of this debt were to be downgraded to CCC.

Additionally, there is a sector skew between loan-only and dual issuers. As Figure 4 shows, the loan-only market has less representation from Cable and Telecom than dual issuers, but is more exposed to Electronics and Business Equipment and Services. Not surprisingly, this sector skew has, in addition to the ratings skew, been a headwind for loan-only performance, as many of the sectors with greater weight in the dual issuer cohort have outperformed this year.

Loan-only deals also tend to provide investors with less protection than loans from dual issuers, based on Covenant Review's Documentation Scoring System, which ranks deals on

FIGURE 5

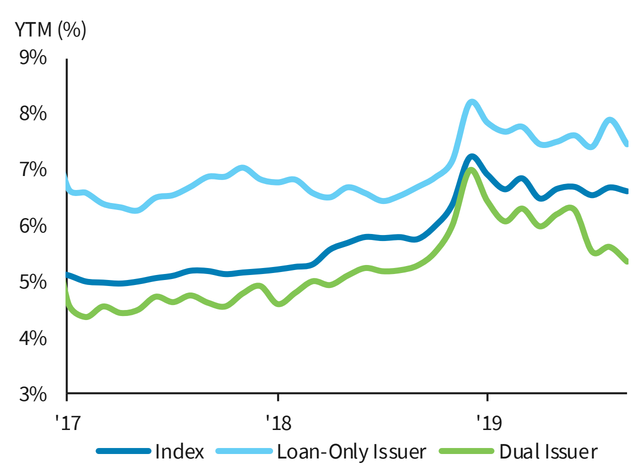
Loan-Only Deals Are Less Protective than Dual Issuer Loans…



Source: S&P LCD, Bloomberg Barclays Indices, Covenant Review

FIGURE 6

…and Yield over 2% More than Dual Issuer Yields

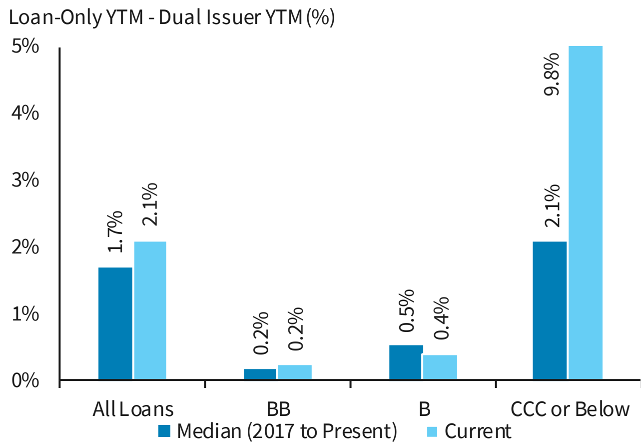


Note: YTM uses spot Libor.

Source: S&P LCD, Bloomberg Barclays Indices, Covenant Review

FIGURE 7

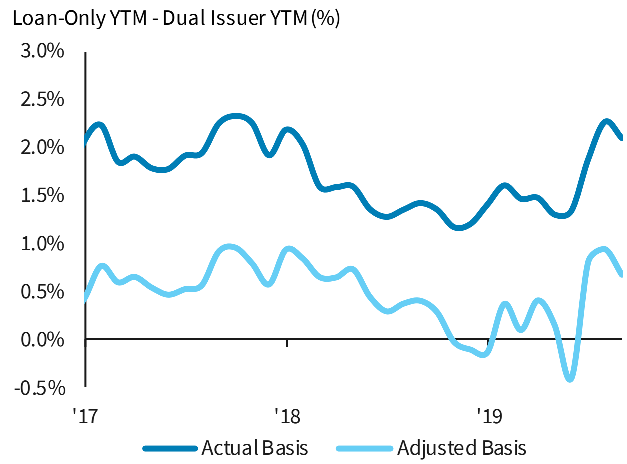
Investors Are Demanding Increased Yield for Lower Quality Loans from Loan-Only Capital Structures



Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 8

The Premium for Loan-Only Issues Has Increased Recently Even When Adjusted for Ratings Differential



Source: S&P LCD, Bloomberg Barclays Indices

many factors from most protective for investors (a score of 1) to least protective (a score of 5). The most significant difference occurs in the CCC bucket, in which loans from dual issuers are much more protective for investors, while CCC loans from loan-only issuers are in line with the other ratings cohorts. There is no material difference, however, in the important B-rated cohort.

Understandably, investors demand more compensation for the lack of subordinated debt, lower rating and smaller size. As Figure 6 shows, loans from loan-only issuers trade with a yield to maturity of 2.1% higher than those from dual issuers, above the average of 1.7% since the start of 2017.

To control for potentially the biggest factor in terms of ratings differential, we look at the yield gap by ratings category (Figure 7). The basis understandably increases further down the quality spectrum, with the lower recovery rate of loan-only structures becoming more pressing as the chance of default increases. The premium charged for CCC or below loan-only structures (albeit a small part of the universe) has increased significantly relative to the longer average, implying increased caution by investors in recent years, having witnessed some large price drops recently.

Figure 8 provides a longer history of the yield-to-maturity basis between the two cohorts, as well as the basis with each cohort having ratings buckets that match the index. The adjusted basis removes the yield differential caused by ratings differences, leaving just the premium investors are receiving for the lack of subordination in the capital structure and potentially liquidity. The current adjusted basis of roughly 70bp is above the 2017-to-present average of 48bp, again highlighting investor concerns about lower recoveries in potential defaults from loan-only capital structures. But we see this as at the wider end of fair value and not necessarily cheap.

Given the ratings skew between dual and loan-only issuers, it is unsurprising that loan-only issuers make up a larger portion of CLO holdings than the broader market, with 65% of CLO assets coming from loan-only capital structures. As we outlined in *Breaking Down B3 Exposure in Loans and CLOs*, CLOs are more exposed to single-B loans than the loan index as a whole, a cohort in which loan-only issuers far outpace dual issuers. This could pressure the yield basis between loan-only and dual issuers further for lower-rated issuers, as a spate of multi-notch downgrades to single-B credits could generate a technical that pressures valuations further.

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