Previously published in the U.S. Credit Alpha
28 July 2017

Feeling Less Insecure

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com
BCI, US

Rizwan Hussain
+1 212 412 7997
riz.hussain@barclays.com
BCI, US

Arvind Kumar
+ 1 646 333 1184
arvind.kumar4@barclays.com
BCI, US

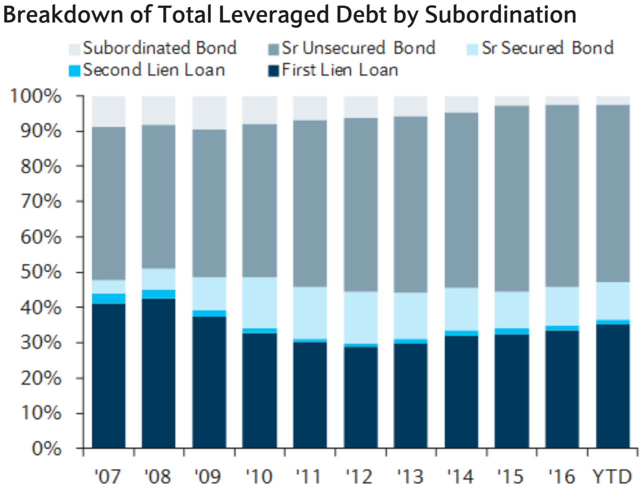
Structural changes in the leveraged finance market have been an increasingly important theme as demand continues to outpace supply. The result has been a deterioration in deal quality and a tug of war between the high yield bond and leveraged loan markets for new issue as a result of higher leverage, looser covenants, and tighter spreads. While we do not expect this to change in the short term, a deeper dive into the changing face of the market reveals some longer-term implications, especially for recoveries.

Figure 1 shows that the loan market has shrunk as a portion of the overall leveraged finance landscape, despite staging a modest comeback over the past five years. Over the post-crisis period, the steady decrease in loans as a percent of total leveraged debt outstanding has been offset by an increase in high yield secured debt. After the share of first-lien loans bottomed at 29% in 2012, the deterioration in covenant standards and easing lending conditions in the loan market have brought the share of first-lien loans back to 35%. Secured bonds are now 11%, materially above 2007 levels of 4%, but also off the peak in 2012. Thus, there have not been many changes to the broader subordination profile, as total secured bond and loan debt continues to compose more than 45% of the entire market. The more lasting change has been a decline in subordinated bonds, which account for only 3% of the market today. This suggests that the changes at the top of the capital stack should not necessarily be punitive for secured recoveries, but unsecured recoveries could be hurt by the lack of subordinated debt below them.

Of course, relying on market-level data alone has pitfalls, given a small overlap between the high yield and loan markets. To pinpoint changing capital structures and trends in issuer preference, we thus focused on the overlap between high yield and loan markets (crossover issuers). We specifically cross-referenced issuers within the Bloomberg Barclays High Yield Index and our leveraged loans universe,[1] comparing the current universe with the 2012 universe by composition and size. Figure 2 shows that the share of crossover issuers has declined steeply from 61% in 2012 and now accounts for only 42% of the loan market. We attribute this to an increase in "loan only" issuance for issuers that tapped loan market more aggressively in the aftermath of the LBO issuance boom post-2012.

FIGURE 1

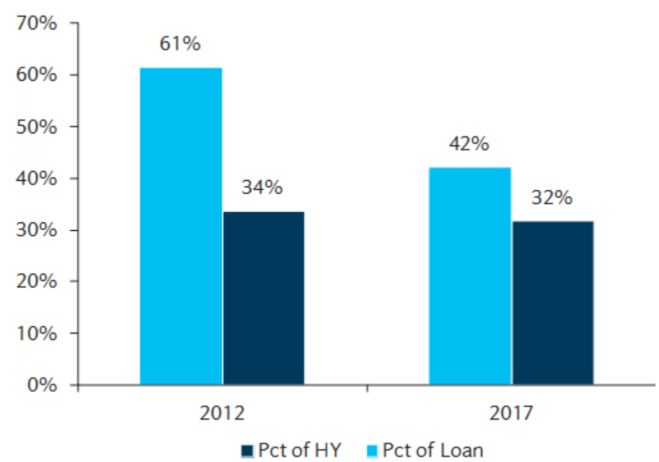
Breakdown of Total Leveraged Debt by Subordination



Source: S&P LCD

FIGURE 2

Crossover Issuers as a Percent of High Yield and Loan Markets

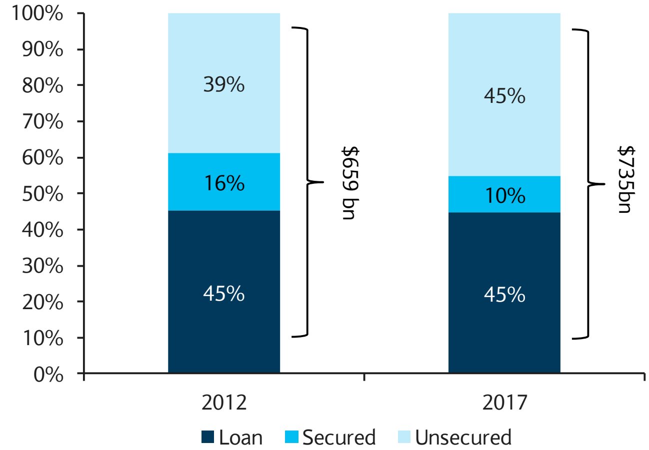


Source: Bloomberg Barclays Indices, S&P LCD, Bloomberg

[1] For the purpose of our analysis, we considered current issuers within the S&P/LSTA Leveraged Loans Index and the retired Barclays High Yield Loans Index (2012).

FIGURE 3

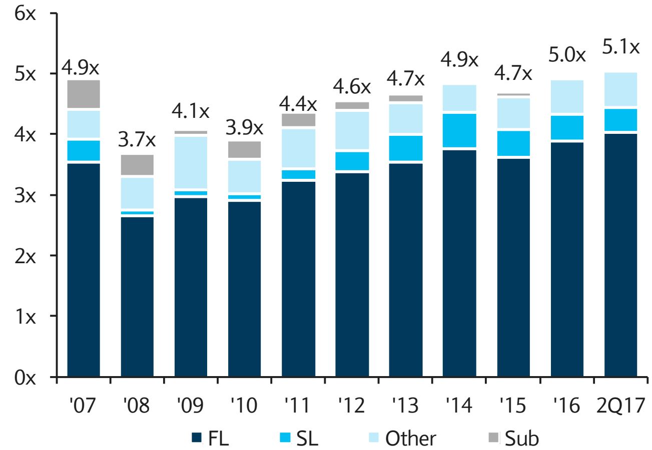
Breakout of Crossover Capital Structures by Subordination



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

FIGURE 4

Credit Multiples for New Issue Loans

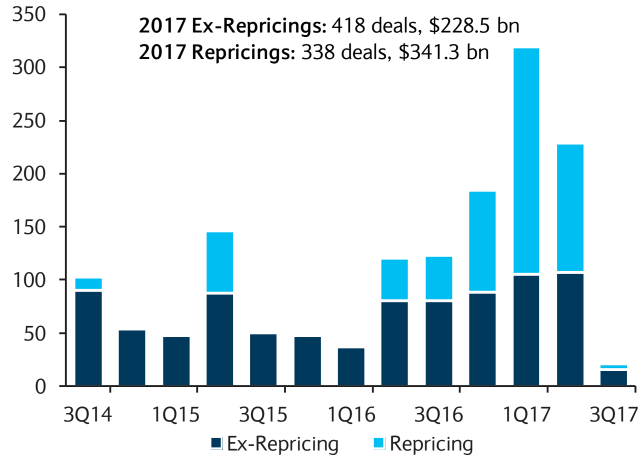


Source: S&P LCD

When we look at crossover issuers in Figure 3, our conclusions change somewhat. While concerns about the lack of subordinated cushion compared with the distant past are still valid for unsecured bondholders, the secured percentage of the capital structure has actually declined for the crossover issuers. This 600bp drop has come entirely from a smaller share of secured bonds as issuers have reverted to more normal capital structures after favoring secured bond markets in the wake of the post-crisis closure of loan markets. This is a more positive data point for unsecured creditors and should help balance out the lack of subordinated bonds when thinking about recoveries in a distressed situation.

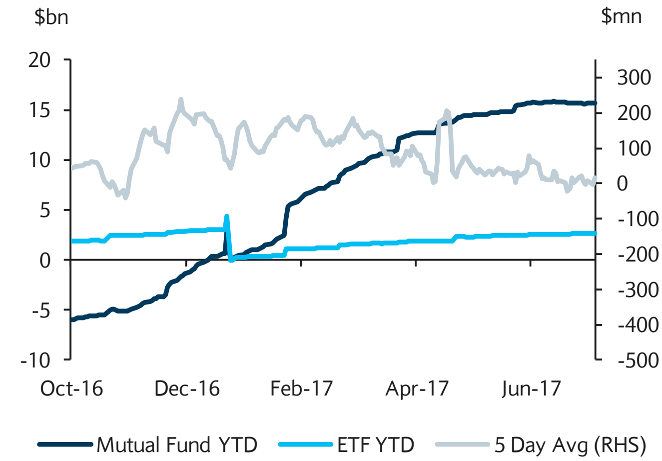
Considering firm earnings growth over the past five years, at first glance, Figure 4 appears to be in contrast to Figure 3, with new issue leverage appearing to increase through first-lien debt. While this points to deterioration in credit quality, these numbers have been obscured by the preponderance in LBO activity for loan-only issuers. In our view, leverage for crossover issuers is more stable than suggested by the headline number. That said, Figure 4 does confirm the lack of subordinated capital behind unsecured bonds for credits in the loan market. As such, while we are concerned about an increase in loan-only issuers, we believe that unsecured recoveries will suffer only modestly, given the thinner layer of secured capital for crossover issuers.

Quarterly Institutional Leveraged Loan Issuance ($bn)



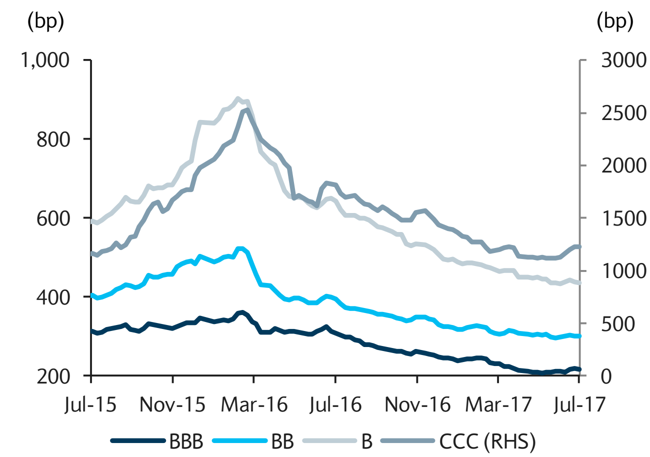
Source: S&P LCD, Barclays Research

Flows to Loan Mutual Funds and ETFs



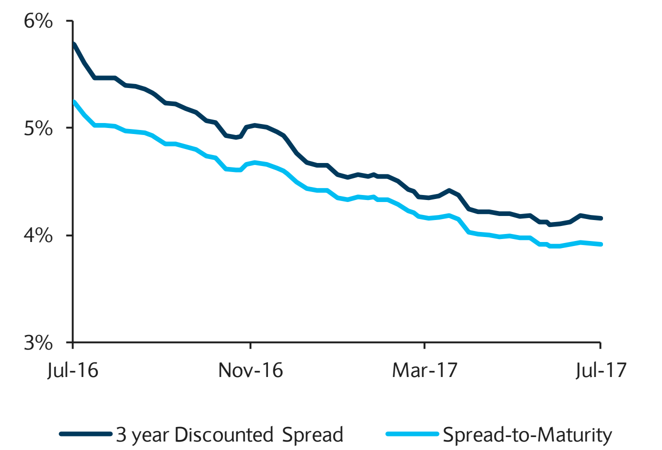
Note: Five-day average includes only flows of daily reporters. Source: EPFR

S&P/LSTA Leveraged Loan Three-year Discounted Spreads by Quality



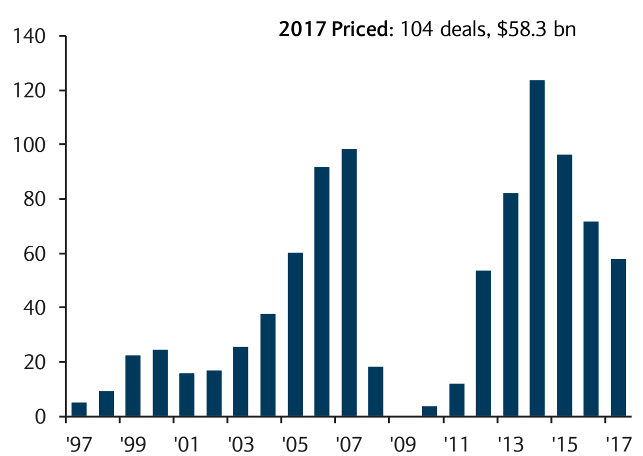
Note: CCC spreads are shown on the right-hand side. Source: S&P LCD

S&P/LSTA Leveraged Loan Index Spreads



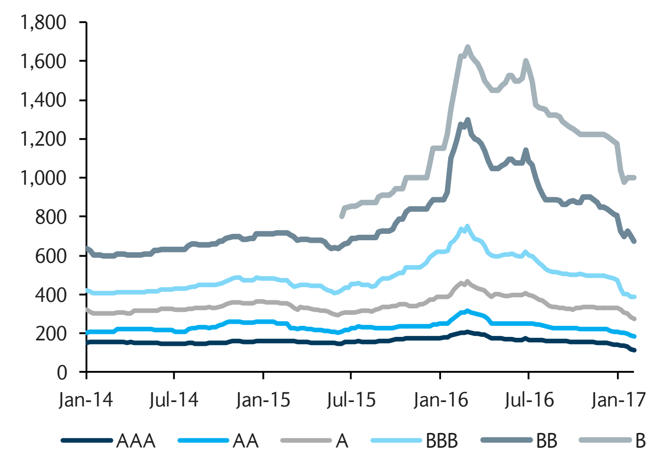
Source: S&P LCD

Annual CLO Issuance



Source: S&P LCD

US CLO 2.0 Spread Performance by Rating (bp)



Note: Spread data from BWIC levels. Source: Moody's, Intex, Barclays Research

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