Market Summary

- The US senior secured loan market has grown rapidly to US$ 1.1 trillion in size. Consistent returns in the loan market have fueled investor attention and capital flow.
- Long-term historical defaults for senior secured loans have averaged around 2.8% since 1999 and ultimate recoveries on defaulted senior loans have averaged around 80% since 1987.
- Low defaults and high recoveries, compared to other credit products, have made senior secured loans attractive from a credit risk perspective.
- CLOs are the largest investors in the senior loan space, and compared to other market participants, CLOs are positioned defensively with better-quality portfolios.

Credit Fundamentals & Outlook

- Corporate earnings' growth has been strong in underlying companies; however, signs of growth deceleration are being observed.
- While debt-to-EBITDA levels are 16% higher than 2007, cash flow coverage ratios are strong which supports current debt levels. Furthermore, loan maturities by 2020 are less than 3%, suggesting limited refinancing pressures in the near-term.
- High debt levels, a rating distribution shift, and overall credit fundamentals suggest 0.4% to 1% higher default rates in next credit downturn compared to the 2007-09 period.
- Subordinated capital cushions below senior debt have dropped, leading to lower recovery forecasts, which in turn are expected to lead to credit spread widening and loan price swings. In the next down cycle, we expect recovery rates to be around 60-65%, lower than long-term historical averages of 80%.
- Loan documentation quality has weakened compared to the 2007-11 period. This is expected to delay default incidence.

Key Lakemore Insights

1. Late cycle behaviors are evident in the market with a weakening of credit fundamentals and loan documentation. In the midterm, we expect an increase in credit spreads and defaults, and a decrease in recovery rates for senior loans.
2. We expect actively-managed portfolios, with strategies that focus on higher-quality credit selection, to fare better than passive portfolios. To build resilient portfolios that can withstand crises or economic stress environments, investors need to be selective, with a focus on higher-quality, lower-risk credit.
3. Investor-imposed constraints on CLOs, and the professional managers' understanding of the market conditions, result in a more defensive positioning of CLOs relative to other investors in the senior loans market, who are showing more risk-taking behavior.

US Senior Secured Loan Market

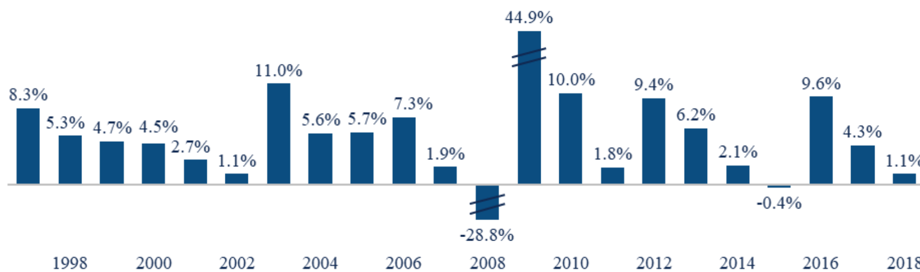
US senior secured loans market has grown rapidly to US$ 1.1 trillion in size

The US senior secured loan market is around US$ 1.1 trillion in size and is a major financing source for US corporations. Since 2008, the loan market almost doubled in size as the asset class attracted various investors looking to increase exposure in floating rate, senior secured credit.

Consistent returns in the loan market have fueled investor attention and capital flow

Since 1997, senior loan returns have been remarkably stable with only 2 negative years. This track record, coupled with the relative resilience of the market and quick recovery in 2008-09, has further fueled the growth of capital inflow into senior loans.

Loan Market Total Returns (%)



Source: S&P LCD

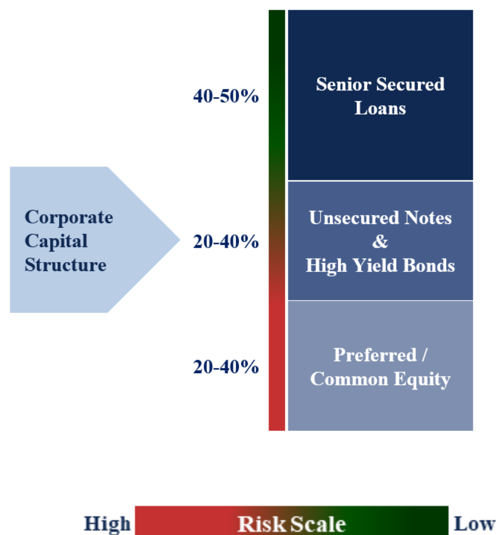
In this Lakemore Insights publication, we review the current status of the broadly syndicated senior loan market and discuss our outlook of this market.

US Senior Secured Loans as an asset class

Senior secured loans are at the top of the capital structure and can withstand significant deterioration in earnings before interest payment or capital risks arise

Senior secured loans are at the top of the capital structure of a corporate. Broadly syndicated senior loans are typically made to companies that have US$ 1 billion and higher in revenues, and loan facility sizes tend to be greater than US$ 500 million. These senior loans have the first right on a company's assets and cashflows, which in the event of a bankruptcy, provide strong protection to investors in the space.

The chart below provides an illustrative positioning of senior secured loans within a typical corporate capital structure.



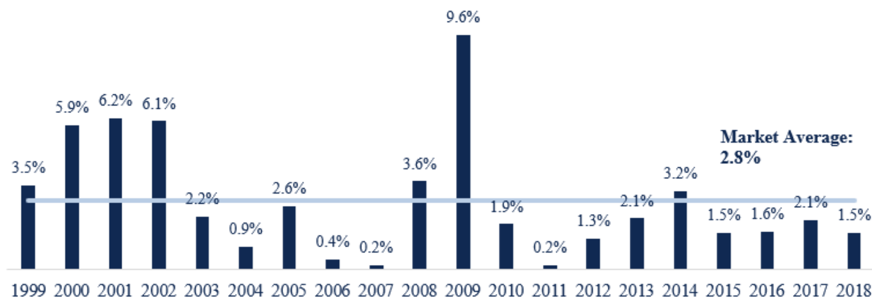
A few important points to note from the capital structure position are related to the level of protection afforded to senior secured lenders compared to other unsecured lenders and equity investors.

1. Senior loans have priority to payments compared to other classes of the capital structure. This results in senior loans being able to absorb significant drops in corporate earnings before interest payments come under pressure.
2. Furthermore, in the event of default, senior loan priority results in a high recovery rate.

The following charts illustrate the default and ultimate recovery rates for senior secured loans historically.

Historical defaults have averaged around 2.8% since 1999

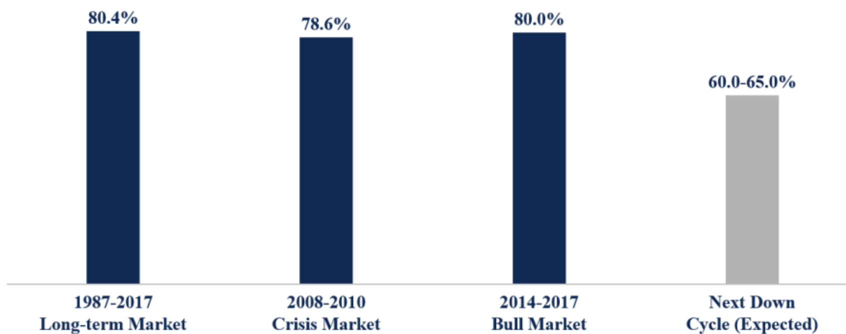
Annualized Market Default Rates (%) – (S&P LSTA Sr Loan Index)



Source: LCD Quarterly S&P Global Market Intelligence.

Median Ultimate Recovery Rates (by market conditions)

Ultimate recoveries on senior loans have averaged around 80% since 1987



Source: Moody's Corporate Default and Recovery Rates; Lakemore analytics.

Default rates in the loan market have averaged around 2.8% since 1999 with significant default spikes in 2008 and 2009. In 2014, defaults were 3.2% as the oil market crisis led to an increase in defaults. Other than these years, defaults in the market have remained relatively benign.

Ultimate recoveries on defaulted loans have averaged around 80% since 1987 and recovery rates in the asset class have remained relatively strong even during the 2008-10 period, where loan defaults had spiked quite significantly.

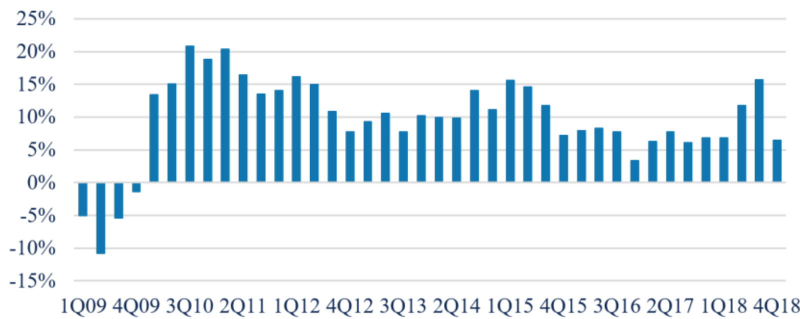
Current Credit Quality Fundamentals

After strong earnings in 2018, earnings growth guidance expected to slow in 2019

Corporate earnings growth has been strong in the senior loan market

But signs of growth deceleration are being built into forward projections

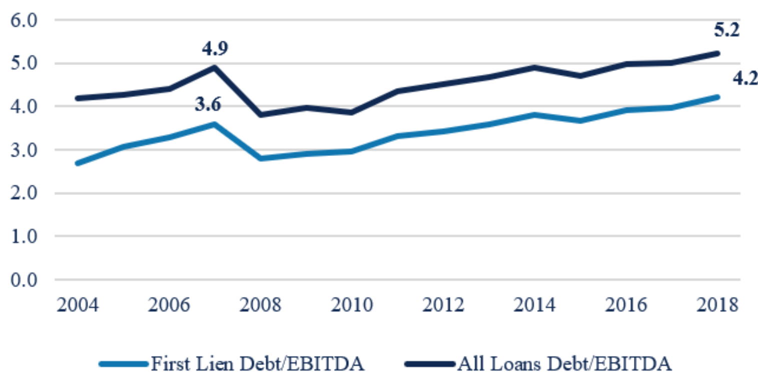
US corporate earnings grew at a strong pace throughout 2018 but growth is expected to slow down in 2019 as per the S&P LCD's Q4 2018 market guidance on forward 12-month earnings. Slowdown in corporate earnings growth and potential decline in earnings could lead to increased credit spreads and defaults in coming years.



Source: S&P LCD Q4 2018.

US corporate debt-to-EBITDA levels have surpassed debt levels seen in 2007. According to S&P LCD, current debt-to-EBITDA levels on First Lien debt stand at 4.2x compared to 3.6x in 2007, which is around 16% higher**.**

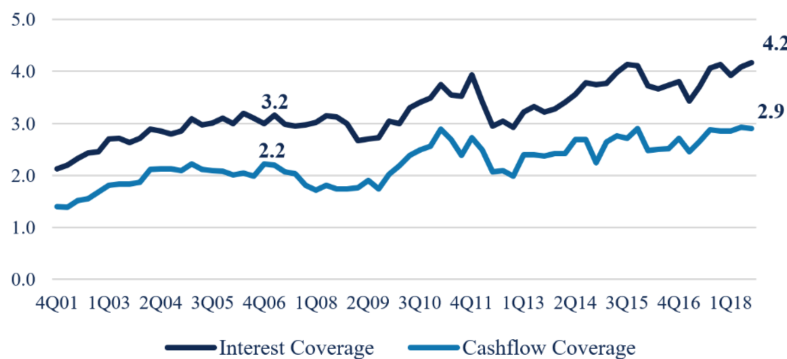
US corporate debt-to-EBITDA levels are 16% higher than 2007



Source: S&P LCD Q4 2018.

Interest coverage ratios, however, have been rising as credit spreads on new issuance has declined to historical tights since 2009 and libor rates have continued to remain benign.

Cash flow coverage ratios are strong which is currently supporting debt levels



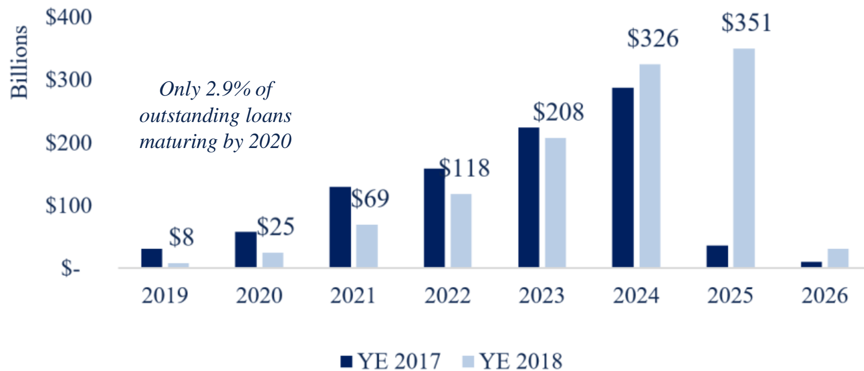
Source: S&P LCD Q4 2018, Lakemore Research.

High levels of debt coupled with high cashflow coverage ratios suggest a debt market which lacks an immediate trigger to fuel defaults. As earnings start to decline or interest rates start to rise, we expect cashflow coverage ratios to come under pressure.

Meanwhile, loan maturities have been pushed back with only 2.9% of total outstanding loans maturing by 2020. This is further expected to keep default rates in check within the medium-term.

Loan maturities by 2020 are less than 3% suggesting limited refinancing pressures in the near-term

Loan Market Maturity Profile

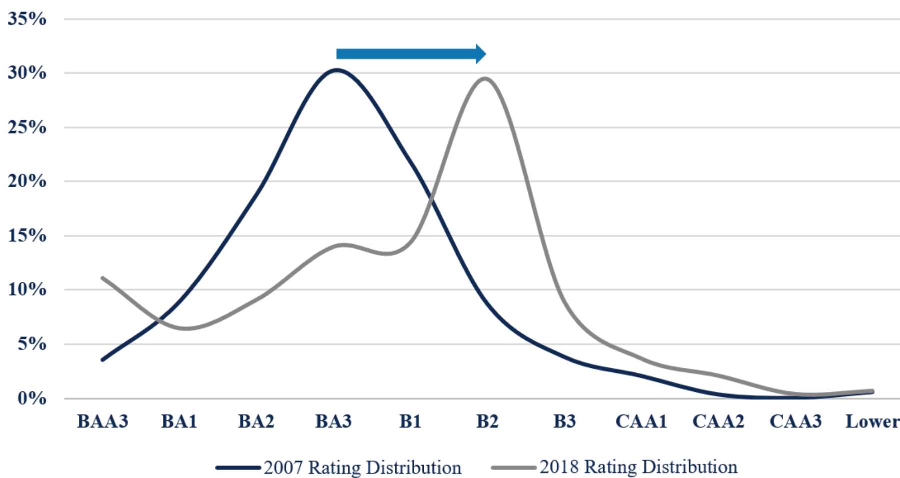


Source: S&P LCD Q4 2018, Lakemore Research.

Loan market ratings' distribution has weakened as debt levels have risen and general borrower quality has weakened. Compared to 2007, the current loan market's modal rating is around 2 notches below at B2/B levels. Based on the shift in ratings' distribution change, we expect default rates in the next credit down cycle to be higher by 0.4 to 1% compared to the 2007-09 default cycle.

High debt levels and rating distribution shift and credit fundamentals suggest 0.4% to 1% higher default rates in next credit downturn compared to 2007-09 period

Senior Loan Market Rating Distribution Change



Source: Lakemore analytics, S&P LCD – Market rating distribution data.

Overall, fundamental factors in the senior loan market are pointing to a low default outlook for 2019-2020 and rising defaults thereafter as corporate earnings start to slow, or interest rates continue to rise.

Overall Default Outlook

Low default 2019-20

Rising expected from 2021

Expect credit spreads to widen

Default rates in next down cycle expected around 0.4% to 1 % higher than 2007-09

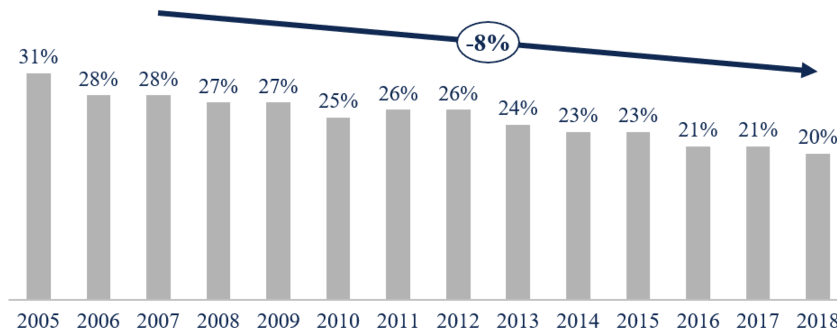
Current Recovery Fundamentals

Subordinated capital cushion for senior loans has deteriorated since 2007

Subordinated debt cushions have dropped leading to lower recovery forecasts.

Subordinated debt cushions under senior loans in the capital structure have declined by around 8% since 2007. Currently, subordinated debt cushions stand at around 20% compared to around 28% in 2007. The impact of lower subordinated debt cushion is expected to impact ultimate recoveries in the broader senior loan market going forward.

Share of Subordinated Debt as a % of Total Capitalization



Source: S&P LCD December 2018; Lakemore analytics.

Lower recovery expectations further expected to create spread widening and loan price swings

Based on our internal models, we expect the ultimate recovery rates on senior loans to range between 60-65% compared to the historical 80% recovery rate. (Source: Lakemore analytics.)

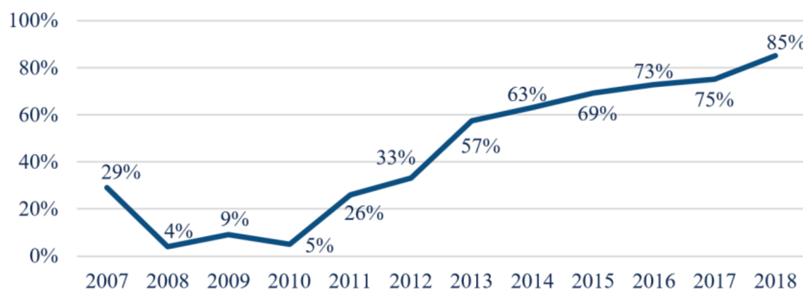
The lower future recovery rate also means that as loans become distressed, prices will drop to the lower recovery value estimates compared to historical recovery levels. This is expected to create more volatility in loan prices and spreads in the next credit downturn.

Weakening Document Quality

Document quality has weakened compared to 2007-11 which is expected to delay default incidence.

Document quality within the senior loan market continues to deteriorate with the share of covenant-lite loans now reaching almost 85% of the loan market. Covenant-lite loans are expected to delay the occurrence of defaults.

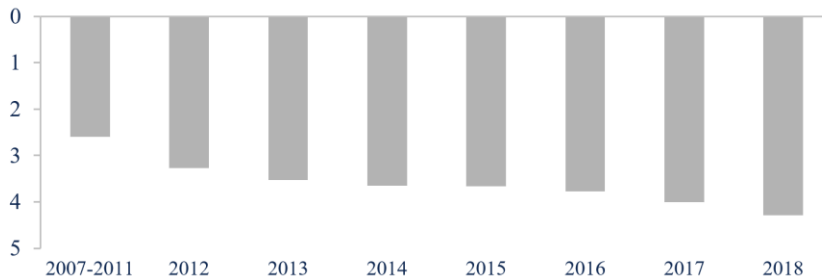
Cov-light loans as a % of all loans outstanding



Source: S&P LCD December 2018; Lakemore analytics.

Moody's June 2018 Loan Covenant Quality score now stands at around 4 compared to around 2.6 during 2007-11 period, a significant worsening of overall documentation quality.

Moody's Loan Covenant Quality Score



Source: Moody's Investor Service, June 2018.

Overall documentation quality and underwriting standards have significantly weakened which makes it extremely important for loan investors to be selective and invest in the market through defensive credit selection. Actively-managed portfolios, with strategies that focus on higher-quality credits, loan by loan underwriting and selection are expected to fare better than passive portfolios that chase returns at the expense of credit quality.

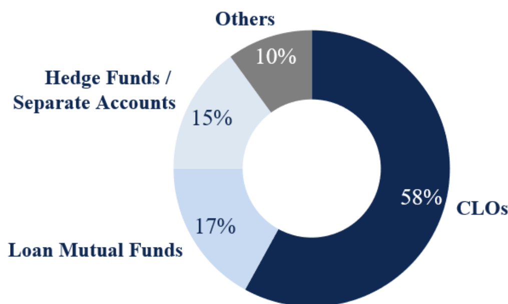
Selective loan portfolio construction with focus on higher-quality, lower-risk credit expected to be more resilient

CLO Portfolios

CLOs represent the largest investor group in the US senior secured loan market at 58% market share, followed by Loan Mutual Funds at 17%, Hedge Funds and Separate Accounts at 15% and Others at 10%.

CLOs are the largest investors in US senior secured loans

US$ 1 Trillion Senior Loans Market
CLOs represent 58% of the market



Source: BlackRock CLO Platform Overview, Apr-18.

CLOs represent actively-managed portfolios managed by highly professional collateral managers who operate under stringent portfolio constraints.

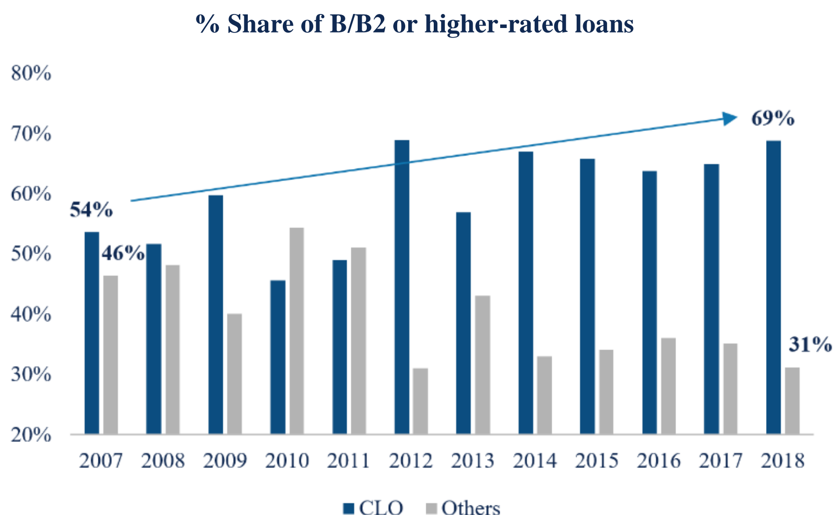
CLO managers, due to the nature of the CLO structure, stand to benefit from an increase in credit market volatility.

The 2005-07 vintages, which were late cycle and went through the financial crises, had a median IRR of 16.7% and were one of strongest CLO vintages.

The quality of loan books currently held by CLOs has improved as CLO managers have allocated a higher percentage to B/B2 or higher-rated loans compared to what they held in 2007.

In 2018, CLOs held 31% B- or lower-rated loans compared to 52% in 2007, a 21% drop in weaker-quality loans. Comparatively, others which include loan mutual funds, hedge funds, and separate accounts have increased their holdings in B- and lower rated loans from 48% to 69%.

CLO Loan books have become much more defensive compared to other investors in the US senior loan space



Source: S&P LCD Quarterly Q42018.

The comparatively defensive portfolio positioning amongst CLO managers has been a result of primarily two factors:

CLO investor-imposed constraints on portfolio quality, and the professional managers' understanding of the market conditions are resulting in a more defensive positioning as opposed to unconstrained portfolios of loan mutual funds and hedge funds, which are showing more risk-taking behavior.

This further supports our hypothesis that investors in the senior loan market should consider selective and defensive portfolios actively managed by specialized managers.

Investors should consider defensive portfolios that are actively managed by professional managers

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